RESEARCH

Economic Outlook

Global

Third Quarter 2012
Economic Analysis

- **Global growth will improve only if already agreed or still pending economic policy measures are fully implemented in time.** The overall weakening of the global economy in 2012 means that the role of economic policy measures is crucial in order to achieve a slight improvement in growth in 2013.
- **The eurozone has not yet resolved its debt and institutional crisis, the main downward risk to our global scenario.** New measures announced could help to improve the situation but speedy and effective implementation is needed.
- **Financial markets respond to global liquidity and the euro crisis.** The sharp fall in interest rates in emerging markets are reliant on low rates for risk-free assets and on plentiful global liquidity supply.

Index

Closing date: August 3, 2012

1. Summary: a slowdown that may deepen unless decisive economic policy action is taken

Global growth will improve only if key economic policy measures are fully implemented in time. Some of them have already been approved but others are still under consideration

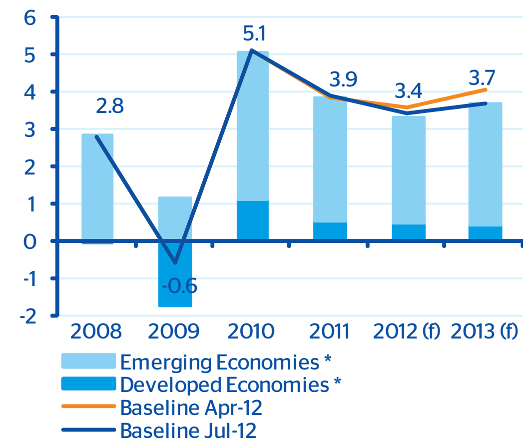
After the deterioration in global economic conditions in the first part of 2012, our current scenario that still envisages a slight economic rebound in 2013 is very dependent on economic-policy issues. Our global GDP growth forecast stands at around 3.5% in 2012-13, but relies on the assumption that several policy measures are implemented around the world. Some of them have already been brought into force but need appropriate implementation; others have been announced but not introduced yet; and, finally, some key measures still have yet to be passed. Policy measures must avoid a financial mess in Europe, an automatic fiscal adjustment in the US in 2013, and help reach higher growth rates in emerging economies. However, if economic policies fail to achieve their goals, the slowdown now in place since 2011 is likely to intensify in 2012 and 2013. That could leave 2013 global GDP growth at its slowest pace in 30 years (except for the 2009 recession).

At a summit in June, the eurozone leaders reached agreements in the right direction to reinforce the currency union: single bank supervision in the euro area, far-reaching plans covering banking and fiscal issues, and growth-supporting measures. However, financial-aid mechanisms that have been approved to ensure financial stability in the eurozone (i.e., EFSF&ESM) must be used in their full capabilities as soon as possible to avoid a financial "accident."[1] This is the only way to make sure that those economies currently struggling to access financial markets have the chance to implement fiscal-consolidation plans and structural reforms. This should include the involvement of the ECB.

In the US, there must be an agreement to prevent that automatic spending-cut measures and the expiration of tax cuts come into force at the beginning of 2013. This "fiscal cliff" would not solve long-term sustainability of the country's public finances and, if all measures materialized, they would push the US economy back into recession in 2013. As the presidential campaign makes any kind of agreement difficult until the election, the surrounding uncertainty over the outcome of this process is likely to play a key role in shaping the economic and financial outlook as we move towards the end of the year.

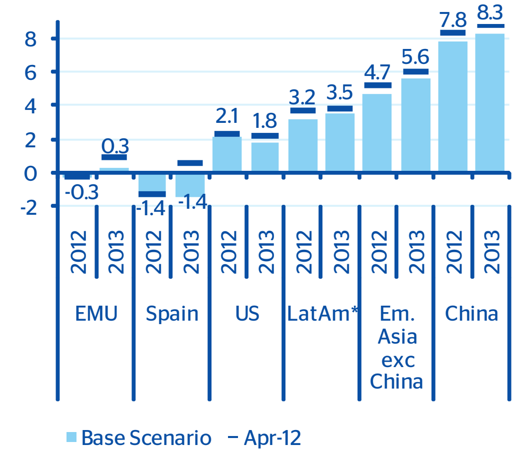
1: The financial "accident" could take various forms, including for example the lack of demand for sovereign-bond issuances of peripheral economies.

Chart 1
Global GDP growth (%)



(*) Growth contributions
Source: BBVA Research

Chart 2
GDP growth by area (%)



(*) Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela
Source: BBVA Research

Meanwhile, in emerging economies with room for policy stimulus, measures are needed to prop up domestic demand so that the effects of the external slowdown are mitigated. Additionally, volatility of capital inflows could increase due to the ebbs and flows of the eurozone crisis and, on the other hand, flows related to a new round of quantitative easing the US Fed is likely to embark on.

Failure to dovetail sovereignty transfer with debt mutualisation at the rhythm that markets demand drags the euro crisis out

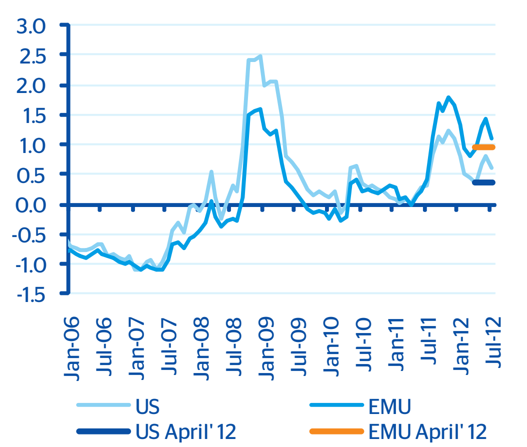
The main uncertainty over the current economic scenario is whether the efforts that the eurozone countries will have to make to reinforce its governance will be preceded by a further deterioration in its financial situation. If this were the case, we think that it will produce massive interventions from EU mechanisms to eventually assure the financial stability of the eurozone. The decisions already taken, if implemented forcefully could suffice but that requires that the measures approved at the end of June are implemented quickly. Those measures aimed to eliminate the risk emerging from the sovereign-banking feedback loop in Spain and to stabilise financial markets across the eurozone with the active use of the EFSF and later on of the ESM actively purchasing bonds in the primary and secondary market. Recent policy measures in Spain to reign in the deficit together with the strongly supportive stance by the President of the ECB are helping to ease tensions.

All in all we have revised downwards our previous forecast (released three months ago) due to continued financial stress stemming from the euro area crisis and ongoing deterioration in global economic confidence. This scenario implies a period of stagnation in the eurozone in 2012-13. Despite this revision, in our view, the balance of risks continues to be tilted to the downside, given the likelihood that approved measures are introduced too slowly due to domestic-policy considerations in some countries. If that were to happen, then the risk of a recession in Europe in 2013 would be relevant, specially in countries such as Spain and Italy.

Eurozone countries have to solve the liquidity squeeze on some markets. Those constraints are a consequence of market participants assigning some chance that a euro break-up may occur. Euro countries are unable to dovetail the transfer of fiscal and banking sovereignty with effective mechanisms of reduction of imbalances at the rhythm that markets demand. As long as this situation continues, the risk of a euro break-up is fuelling the fragmentation of financial flows across the eurozone and impeding funding access for those economies with a net debt position with the rest of the zone. A fast implementation of financial-aid mechanisms and their reinforcement in terms of size and access to ECB's funding are key factors to eliminate the risk of a eurozone break up. However, in our opinion this extreme outcome is a tail risk; sooner or later, the measures needed to set up common institutions for banking supervision, deposit guarantee and banking resolution will be approved. Although there is political will to reinforce European currency-union institutions and governance, the implementation of appropriate measures are lagging behind. In the end, those measures will imply a transfer of national sovereignty to the European institutions and, at the end of the process, some form of liability sharing (debt mutualisation). That will also happen as for the fiscal policy, for example in the form of national consolidation plans having to be submitted to European institutions. If the challenges ahead are met satisfactorily, global growth could gradually gain traction during 2H12.

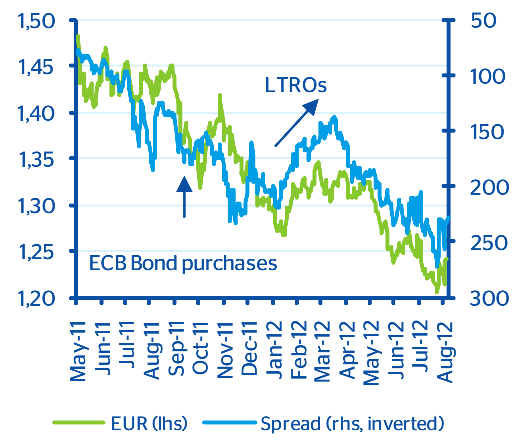
In the case of the US, the downward revision to our outlook for 2012 and beyond has been driven by a combination of disappointing growth figures in 1H12 and the impact of a high financial stress coming from the euro area. As a result, emerging economies are likely to be the main drivers behind the slight acceleration in global GDP we expect for 2013. In Latin America, despite a generalised downward revision in growth forecasts compared with three months ago, estimates for Mexico (3.7% and 3.0% for 2012 and 2013, respectively) remain unchanged thanks to upbeat activity data in 1H12, the continuation of favourable financing conditions in the domestic market, and gains in competitiveness. In Brazil, growth forecasts have been significantly revised downwards (to 2.2% from 3.3% in 2012) due to the impact of the external environment and to some domestic issues such as the slowdown in credit markets and increasing competitiveness problems. Even though activity is still expected to recover in the quarters ahead following the unprecedented softening of monetary conditions, the recent moderation warns against the current growth model and its excessive focus on private consumption and credit expansion.

Chart 3
BBVA Financial Stress Index (*)



(*) Tracks the trend of a series of financial variables, including: stock market volatility; interest rates and exchange rates; sovereign, credit, and corporate risk; and liquidity tensions
Source: BBVA Research

Chart 4
Dollar-euro exchange rate and Spanish and Italian risk premiums. Simple average spread vs. 10Y Bund, bp; index 1 Jan 11=100



Source: BBVA Research and EPFR

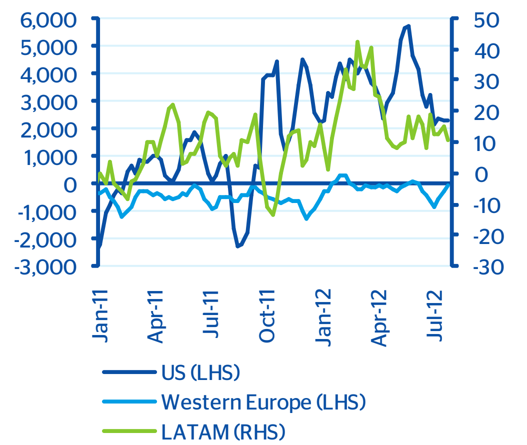
As for Asia, growth in the first half of the year slowed in China more than expected. In line with the weaker global outlook, we have accordingly revised our projections for 2012-13 down. Nevertheless, monetary and fiscal measures to support growth should lead to a pickup, with growth in 2013 rising to 8.3%, a half percentage point higher than in 2012. Elsewhere in the Asia region there is also room for policy stimulus to support growth. But there are downside risks, including a more severe worsening of external demand and a continued slowdown in China, exacerbated by ongoing domestic financial fragilities.

Abundant liquidity, accumulated imbalances and doubts about the ability of policy makers to resolve the euro crisis are changing the risk perception across assets in developed and emerging markets

The outcome of the current economic problems is highly uncertain because there are political-economy considerations at stake that may not be consistent with the incentives to fix a supranational crisis. The risk scenario that dominates in the forecast horizon (2012-2013) appears to be more focused on the developed economies and in particular, on the eurozone. These emerging economies have more room to manoeuvre than developed economies when it comes to demand policies (fiscal and monetary), and also have, overall, lower accumulated imbalances. As a result, there have been increasing capital flows from Europe into the US and the emerging markets, including those in Latin America.

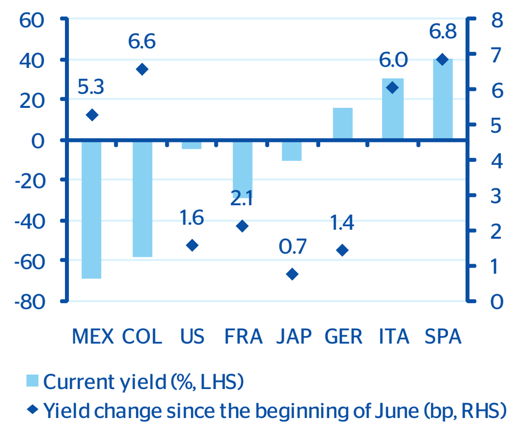
These shifts in financial flows are a reflection of the level of uncertainty and the fact that risk is focused on developed economies. Both factors have led to a change in the risk character across assets in emerging and developed markets. Since the end of May (when markets started pricing in that the US economy was running out of steam) yields on bonds that are traditionally regarded as risk-free sovereign assets (US and Germany) have fallen to historically low levels. Since the end of June, doubts surrounding the ability to reach a rapid solution to the euro crisis have been pressing in the same direction. Peripheral sovereign bonds have been perceived as riskier, whereas yields on emerging-market bonds such as Mexico's[2] and Colombia's have fallen to all-time lows. Record foreign inflows are searching for returns in economies as isolated from the source of the crisis as possible, with good macroeconomic policies and growth prospects; in countries where any direct channel of contagion is relatively narrow, and where the room for manoeuvre in economic policies is ample.

Chart 5
Sovereign debt flows (USD bln)



Source: BBVA Research and EPFR

Chart 6
Long-term (10Y) bond yields, changes since the beginning of June (bp)



Source: BBVA Research

But there are risks to the sustainability of this scenario. Apart from changes to local inflation or growth outlook that may cause rising yields, global factors, such as systemic shock in the eurozone could wipe out all the safe-haven value recently gained by certain emerging-market assets, e.g. those in Latin America. In the case of a systemic event, it remains to be seen whether domestic strengths (e.g., lack of fiscal imbalances) would be preserved in the event of a "Lehman-type" shock. In the event of a systemic risk, it is likely that only the assets of economies that have their own currency and a central bank that acts as the lender of last resort, and do not have any significant external imbalances, will be regarded as risk free.[3] On the other hand, additional expansion of the Fed's balance sheets could encourage investors to move out of fixed income and into equity markets, particularly if there are no clear signs of further easing in domestic monetary-policy expectations.

2: In the case of Mexican bonds, the inflows may even have been intensified by investors betting on a change of composition of the bench-mark indices used by global fixed income portfolios.
3: Chapter 3 of the IMF Global Financial Stability Report (April 2012) is dedicated to the implications of low supply of risk-free assets for financial markets stability.

2. Europe continues without resolving its debt and institutional crisis

The financial tensions continue to be high, with Greece, Spain and, by extension, Italy at centre stage

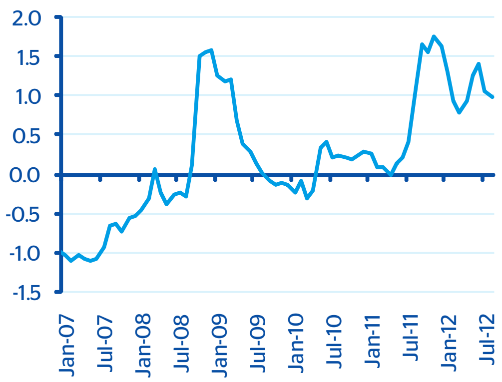
The financial markets in Europe have again experienced high levels of volatility in recent months, also affecting the overall world economy. **This volatility reflects the difficulties that eurozone policymakers are having in putting an end to the debt crisis and the doubts that exist regarding the euro project.**

On one hand, the eurozone went through a difficult situation in Greece, although in the end it was overcome. The restructuring plans for the Greek debt, agreed upon in April, led to a period of political instability, which after two general elections, has given way to a coalition government, committed to the permanence of Greece in the euro and to the reform programs.

Nevertheless, financial tensions soon intensified, in particular affecting Spain and Italy. The causes of this financial deterioration can be found in **the doubts in the markets regarding the restructuring plans of the Spanish financial system,** even after securing up to 100 billion euros from the eurozone funds, and the generalized perception that, despite the progress made, the measures adopted up to now by the European authorities are not enough to resolve the crisis.

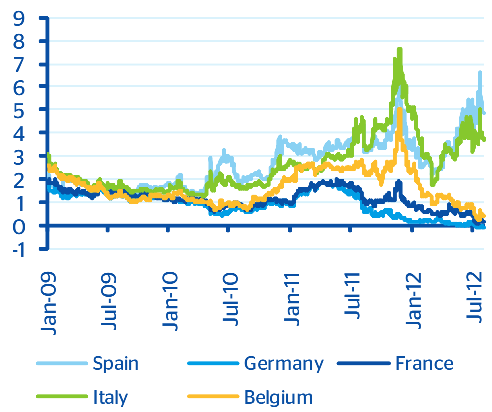
The rebound of financial tensions not only led to very notable drops in yields in the countries of the European core, but, in a novel movement, has also extended to other countries such as **France and even Belgium. Interest rates in the short segments of the curve have even become negative.** This movement is explained fundamentally by the capital flows toward safe assets, which intensify when there are episodes of volatility in Europe. In turn, in the countries in the periphery, in particular Spain and Italy, interest rates on sovereign bunds and their spread over Germany's reached maximum levels since the adoption of the euro, even greater than those of the previous crisis episode (the end of 2011). Another outstanding note is that **the countries already under bailout programs, Ireland and Portugal, have shown a relatively more favorable performance than Spain and Italy,** so that the spread between Portuguese and German bond yields have narrowed and to an even greater extent so have Irish/German bond spread. Ireland issued short-term bonds for the first time since Ireland was bailed out.

Chart 7
BBVA Financial Stress Index in the EMU (*)



(*) Tracks the trend of a series of financial variables, including: stock market volatility; interest rates and exchange rates; sovereign, credit, and corporate risk; and liquidity tensions
Source: BBVA Research

Chart 8
Interest rates: 2-year sovereign bond yield (%)



Source: Bloomberg

The measures announced could improve the situation, but their rapid implementation would be needed

In recent weeks some economies of the eurozone **– Italy, France and Spain – have announced additional fiscal measures** with the aim of complying with the goals established for this year. These adjustments, however, do not imply an additional intense fiscal contraction, since they just try to implement the necessary measures to meet the deficit goals already presented by the countries in their plans for stability and growth.

The recent weakness in the economic cycle, muted inflation risks and mounting financial tensions pushed the European Central Bank to reduce their interest rates on main refinancing operations (and also that of the deposit and marginal lending facilities) by 25 basis points, for the first time placing interest rates below 1%, at 0.75%. The ongoing deterioration of cyclical conditions in Europe, even in the core of the area, is perceived as the materialization of the debt crisis. **The ECB also adopted measures that continue to support the liquidity of the banking system.** On one hand, it extended, until the end of the year, the unlimited short-term liquidity auctions and made collateral policy more flexible so that the banks can have access to liquidity with a broader array of assets. As regards other non-standard measures, such as the purchase of bonds in the secondary market (SMP), the ECB has, so far, remained inactive, despite high yields on Italian and Spanish debt. **The ECB stated at its last meeting (August 2nd) that national economic policies will have to be subject to strict conditionality, as a necessary condition for any support. The national governments, as well as the European authorities, are responsible for initially taking the necessary adjustment measures under strict conditionality to stop the tensions in the debt market.**

But, without a doubt, it has been the agreements of the European summit at the end of June that could most influence advancing toward a more definitive resolution of the debt and institutional crisis of the eurozone. The summit provided a positive surprise, as opposed to the scant expectations, and went beyond well-intentioned statements. Specifically, at the summit, progress was made in:

- An agreement to **advance decidedly and rapidly in the design of measures that will lead to a fiscal and banking union,** on top of the decision already made to proceed to a common system of supervision, which should be designed by the end of 2012.
- Using the funds in the European Stability Mechanism (ESM) for the **direct recapitalization of the banking system,** once the single banking supervision of the eurozone is established. **Such funds will not have seniority over other creditors.** This will serve to break the sovereign-banking feedback loop.
- **Clarifying the possibility that the ESM will intervene in the sovereign debt markets** and also without additional conditionality to that already contained in the European semester recommendations.
- **Implementing a program for boosting growth,** of 120 billion euros for all the European Union, equivalent to 1.1% of the GDP of the eurozone, although the program does not include new funds.

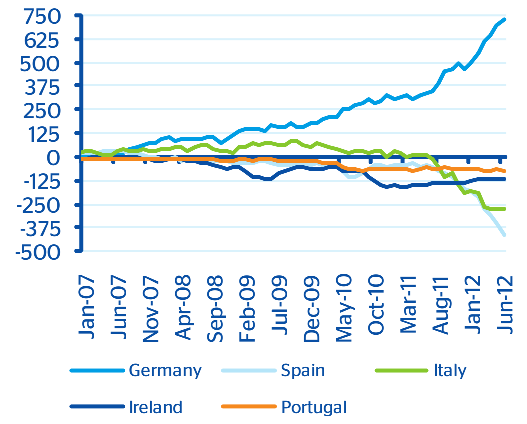
Even so, the agreements were counteracted by some negative factors: 1) the resources of the ESM have not been increased, which limits the credibility of the firewall; 2) details are still lacking regarding the scope of the agreements; the implementation risk is high; 3) the dissonance of voices among the European governments and institutions raises uncertainty regarding what was finally agreed upon and reduces the positive impact of the announcements, although in recent weeks this discord has been offset by EBC statements in support of the euro; and 4) the proposals regarding the long-term solution (fiscal union, banking union and greater political union) will begin to be debated in October. It is uncertain if the current level of tensions will allow for time to wait for these agreements.

The range of possible scenarios is broad but with political will there is ample room to expect that the euro breakup crisis will end

In this context, **the road to be taken by these events will depend on the measures adopted by the authorities.** The measures approved at the end of June, if implemented appropriately, could be enough to avoid a financial "accident" that would affect with it the whole world economy. **But for this, it will be necessary for these agreements to be implemented rapidly, together with the effective use of European stabilization mechanisms in the primary and secondary bond markets.** This will allow alleviating the existing liquidity restrictions in some markets, derived from the probability that the markets assign to a euro break-up. In this sense, the declarations made by the ECB president on the irreversibility of the euro and the capacity of the central bank to ensure its continuity served to moderate tensions. The ECB looks set to activate a new bond-purchase program. Yet to do so, the ECB requires governments to seek financial help from the eurozone bailout funds and to accept strict conditionality under the recommendations of the so-called European semester. The ECB has not ruled out the introduction of unconventional monetary-policy measures, which could even lead to some form of quantitative easing. The specific details of these measures will be announced in coming weeks.

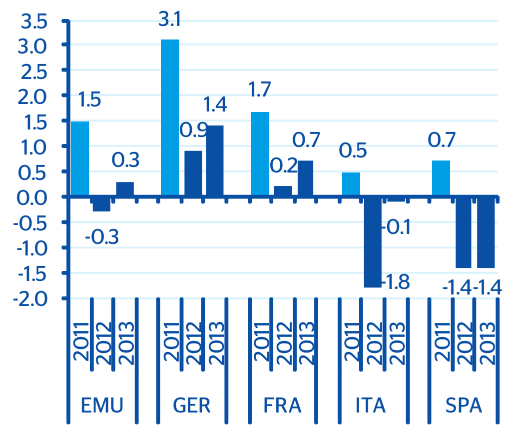
As of this time, **euro countries are unable to dovetail the transfer of fiscal and banking sovereignty with effective mechanisms of reduction of imbalances at the rhythm that markets demand.** As long as this situation continues, the risk of a euro break-up is fuelling the fragmentation of financial flows across the eurozone and impeding funding access for those economies with a net debt position with the rest of the zone. **A fast implementation of financial-aid mechanisms and their reinforcement in terms of size and access to ECB's funding are key factors to eliminate the risk of a eurozone break-up.** However, in our opinion this extreme outcome is a tail risk; sooner or later, the measures needed to set up common institutions for banking supervision, deposit guarantee and banking resolution will be approved. Although there is political will to reinforce European currency-union institutions and governance, the implementation of appropriate measures are lagging behind. In the end, those measures will imply a transfer of national sovereignty to the European institutions and, at the end of the process, some form of liability sharing (debt mutualization). That will also happen as for the fiscal policy, for example in the form of national consolidation plans having to be submitted to European institutions. **If the challenges ahead are met satisfactorily, global growth could gradually gain traction during 2H12.**

Chart 9
Eurosystem/Target net balance (bln euros)



Source: ECB

Chart 10
GDP growth in the eurozone (%)



Source: BBVA Research

Under the assumption that European authorities implement appropriate measures, in our scenario we envisage that the risk premiums and liquidity restrictions will gradually decrease starting in September, although it will take time. With a lower risk of a financial accident, the European economy will be able to pull out of the current recession toward the end of the year and will grow very moderately in 2013 (0.3%), although recession this year cannot be avoided (-0.3%) due to the accumulated drop in activity. **Those countries in Europe's periphery will continue to experience a severe recession, due to the fiscal adjustments and the deleveraging process.** Those in central and northern Europe will post limited growth, although in the second quarter, they have not been immune to the deterioration of the external environment, both due to the weakness of internal demand as well as lower global demand.

3. US: Little sign of growth, but downside risks rise

Uncertainty on the automatic fiscal adjustment and weakness in the eurozone threaten growth

US economic growth slowed in the second quarter of 2012, with the country on the fragile path to recovery, **owing to weak private consumption as well as investment.** Nevertheless, in the second half of the year the pace of growth is expected to stabilise at about 2%, in line with the forecast presented in our May issue of Global Economic Outlook. **The weakness of the economic cycle appears temporary,** as suggested by most of our economic activity indicators.

The first GDP growth estimate in 2Q12 was 1.5%, on an annualised quarterly basis, largely reflecting weakening private consumption (PCE), which growth rate slowed to 1.5% from 2.4% in the first quarter, while growth in residential and non-residential fixed investment was also lower. This growth figure, which is lower than expected by the consensus, is slightly below the 2% figure posted in 1Q12. If consumption does not increase enough to offset inventory replenishments, we might witness a lower rate of output in coming months. Labour market conditions remain weak in light of lower job creation in 2Q12—an average of one third lower in quarter-on-quarter terms. Nevertheless, **our view, in line with that of the consensus, continues to be that current data point only to a temporary slowdown and not to a collapse in growth,** for several reasons: the resolution of the European crisis, the current global expansion, moderate fiscal austerity in 2013 and the marginal negative impact relative to political uncertainty.

Although the pace of economic growth in the United States is significantly lower than in previous recoveries, the gap between the growth rate in that country and that of Europe continues to widen (Chart 11): our forecasts assume that growth will pick up in the second half of the year, and that the latter period will prove less buoyant once the worse-than-expected figures for the first part of the year are made known. **Our growth forecasts are consequently being revised slightly downward** compared with those given in our previous Global Economic Outlook (published in May): 2.1% in 2012 and 1.8% in 2013.

The decrease in commodity prices seen in recent months has translated into a **downward revision of inflation,** while core inflation is expected to remain stable at about 2%. Long-term inflation forecasts remain anchored and, in any event, the weak economic cycle should help contain labour and production costs.

All in all, in our opinion, the risks to these growth forecasts are tilted to the downside. In the United States, an agreement must be reached avoiding the entry into force in 2013 of automatic budget cuts and the expiration of tax cuts. Fiscal contraction is not likely to improve the long-term sustainability of public finance in the United States, pushing the US economy to recession in 2013. In addition, the presidential-election campaign, currently underway, makes any type of policy agreement unlikely at this time. The uncertainty on the outcome of this process is therefore likely to play a key role for the economy and finance as we approach the end of the year.

US headed to recession in 2013, unless fiscal contraction is averted. There is much political uncertainty given that budget cuts are to be triggered before the next president is sworn in

If Congress does not take a decision before 31 December, investment-income taxes will rise significantly, with a hike in the capital gains tax from 15% to 20%, and up to approximately 40% on dividends for the highest income brackets. It is not surprising, then, t**hat uncertainty on the fiscal adjustment remains high,** for at least three reasons. First, because of the possibility of the debt ceiling being reached in December 2012. Second, because the package of budget cuts will be triggered before the next president is sworn in. Lastly, because the dividend-tax increase has so alarmed companies with stable cash flows that distribute large dividends and households that supplement their income with dividends.

The simultaneous expiration of tax exemptions, such as the end of the provisions on the income and wealth tax and payroll-tax cuts, the Budget Control Act or the Affordable Healthcare Act, among others, equivalent, all told, to 3.9% of GDP, threatens the U.S. economic recovery. **The scenarios that we view as the most likely would result from a compromise for a lower deficit adjustment in 2013**—with only one third of the total automatic cuts taking effect—meaning that growth in 2013 would decline moderately. Our estimates show the potential impact in 2013 of the different options for the US economy. In the worst-case scenario this would mean: lack of agreements (brinkmanship) , with a high multiplier effect, this would mean a 3.5% drop (Chart 12).

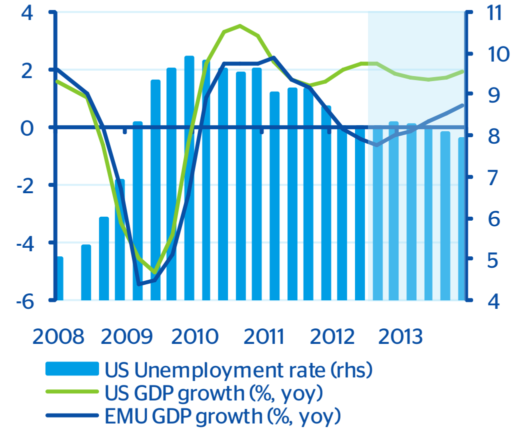
Hence, **an automatic fiscal adjustment in the hypothetical context of a worsening of the European crisis**—with contagion partially being offset by lower long-term rates and energy prices—**and the hard landing of the Chinese economy would result in a severe recession in the United States in 2013.** However, the most worrisome issue is perhaps the fact that long-term fiscal consolidation has still not been tackled.

A third round of quantitative easing (QE3) is likely, although its effectiveness may be more limited

The Fed's most recent speeches, as well as the details of the minutes of the most recent meeting of the Federal Open Market Committee (FOMC), held from 31 July to 1 August, point to **growing concern both over domestic growth and over trends in Europe, which may lead the Committee to introduce a new round of quantitative easing,** that is a third round of asset purchases—probably mortgage-backed securities—in order to bring down long-term rates.

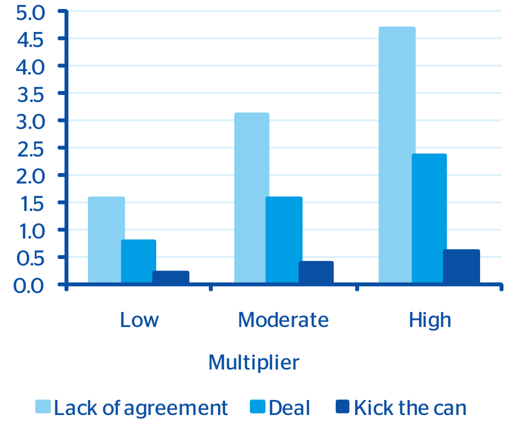
The extension of the so-called Operation Twist at the 20 June meeting bought the Fed time to debate the effectiveness of a new round of monetary-policy easing. Although no new measure was presented at the most recent meeting—evidence of the strong ideological division among its members—**Bernanke's strong bias in favour of quantitative easing to support economic recovery was clear in his most recent speech.** Although such a measure would have more limited effectiveness, the Fed is reportedly poised to make a more aggressive move if it detects greater weakness in the US economic cycle. Clearly, **in light of the expectations generated by the FOMC, we cannot rule out the possibility that the Fed will announce QE3 at its September meeting.**

Chart 11
US Growth and Unemployment Rate (%)



Source: BBVA Research based on Haver Analytics

Chart 12
US: Decline in GDP growth from "fiscal cliff", %2013



Source: BBVA Research

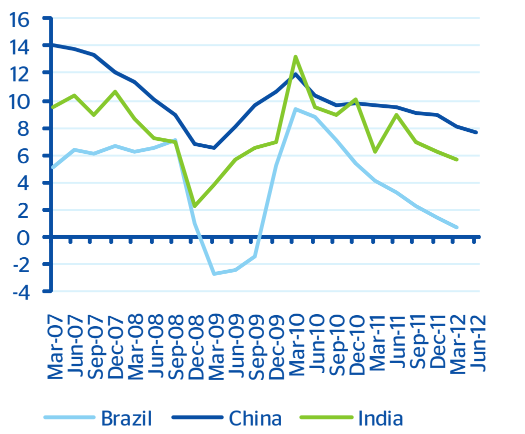
4. Deceleration in emerging economies that will be offset with support from economic policy

The largest emerging economies have decelerated more than expected, in part as a result of policies but also because of the European crisis

In recent months, **the slowdown in the emerging economies of both Latin America and Asia, which began in late 2011, has intensified**. This is especially the case of the three largest emerging economies. According to the most recent GDP growth figures for China, in the second quarter of 2012 the Chinese economy continued to slow and recorded its slowest growth in three years, although it was still quite high (7.6% yoy). Growth in India has fallen to its slowest pace since 2004 (5.3% yoy, according to data published up to the first quarter). In Brazil, in turn, economic activity was considerably more disappointing (0.8% yoy, which implies virtual stagnation—the qoq figure was 0.2%).

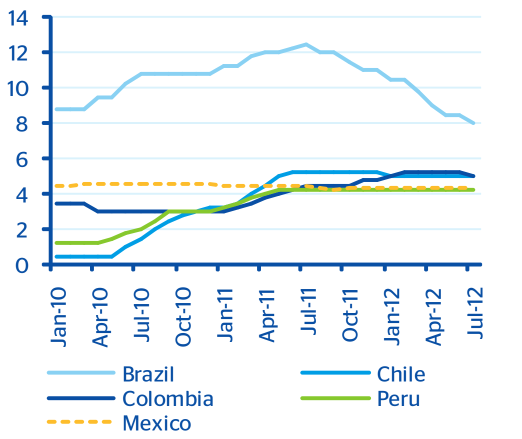
To a large extent, the slowdown is the result of economic policies adopted in the emerging economies themselves. Those with more room for manoeuvre were able to utilize the macroeconomic policy instruments at their disposal to counter the decline in global activity in 2008 and 2009. These policies succeeded in spurring growth, but at the expense of an aggravation of some macroeconomic imbalances and **the emergence of overheating risks.** These risks were also addressed with policies, including a gradual tightening of fiscal and monetary policies, with a few exceptions. These measures were compatible with continued high rates of growth until a few months ago. The most long-lasting policy tightening effects, or less easing effects,—depending on the case in question—appear to have been felt throughout the first half of 2012—as was to be expected—in terms of domestic demand. But, in addition, **growth in emerging economies was also dragged by a fall in their external demand as a result of the eurozone crisis.**

Chart 13
GDP growth rate in emerging markets (% YoY)



Source: Haver and BBVA Research

Chart 14
Latin America: policy interest rates in inflation-target countries (%)



Source: Bloomberg

Emerging economies have begun to use their room for manoeuvre to implement pro-growth policies

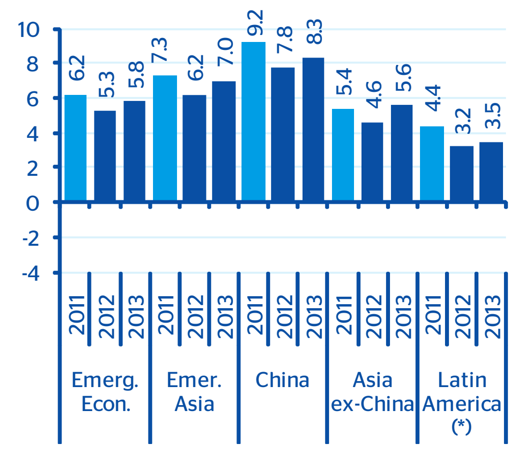
Two main concerns emerge from the current slowdown. The first relates to how these economies will respond to the cyclical weakness stemming from the more downbeat mood in the global economy. This first concern is compounded by questions on how they will deal with risks stemming from a worsening situation in Europe, which would intensify the decline in external demand and may also give way to a more far-reaching systemic shock. The second concern relates to a longer-term point of view. It results from questioning the ability of some emerging countries to return to the high growth rates they used to record in previous years, especially those economies whose growth model was based on factors that do not prop up long-term growth. These factors include borrowing or high local commodity prices that are sensitive to the global economic cycle.

In the short term, **most emerging economies have ample room for economic policies to address cyclical weakness.** Indeed, one of the common features over the first half of 2012 was that, in economies in which the adjustment was proving to be intense, **authorities have partially reversed course and embarked on a path to a more lax monetary policy.** For example, China is stepping up its infrastructure spending, affordable housing construction, and providing support to consumption through tax cuts and subsidies.. Brazil's central bank left interest rates at 8%, at a meeting in July, 4.5 pp lower than a year ago. The remaining Latin American countries with inflation targets have brought monetary tightening to a halt. Part of this monetary-policy easing stems from t**he recent positive performance of inflation,** with the support of favourable energy prices.

Our short-term scenario assumes that **emerging economies with room for policy manoeuvre will continue to use it.** Many of these economies have ample room for further monetary easing, and for now they are not precluded by short-term macroeconomic imbalances from taking advantage of these policies, given that the risks of overheating were appropriately addressed during the period of monetary tightening in 2010-2011. The only issue that might prevent them from making more intensive use of monetary policy is the possible impact of high food prices on inflation. Fewer countries are in a position to make more intensive use of fiscal policy, but most emerging countries have relatively sound public accounts and some of them could adopt an expansive fiscal policy in addition to resorting to monetary policy. In any event, whatever the combination of policies that are finally implemented, **countries must compensate for the adjustment in external demand and the deceleration of domestic demand** without overlooking the fact that financial flows may become more volatile as a result both of the ebb and flow of the European crisis and the possible new round of quantitative easing in the US.

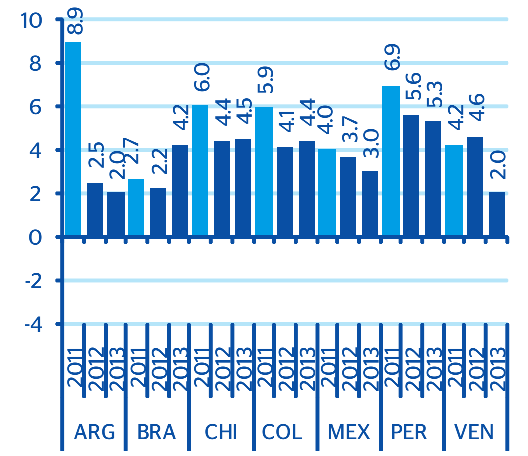
Therefore, our scenario expects that emerging economies will make more intensive use of economic policy in the rest of the year and hence that economic growth will begin to pick up in the second half of the year. This upturn will not make up for the weakness seen in the first half of the year and, on average, growth in 2012 will be lower than in 2011. Nevertheless, the more upbeat mood that we expect will become more noticeable in around 2013.

Chart 15
GDP growth rate in emerging economies (%)



(*) Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela
Source: BBVA Research, IMF

Chart 16
GDP growth rate in Latin America (%)



Source: BBVA Research, IMF

Latin America is on the road to a slightly higher pace of growth in 2013, although there are concerns on how strong Brazil is

In Latin America, forecasts for 2012 continue to point to a slowdown somewhat sharper than expected three months ago (especially because of the greater drag on growth caused by the slump in Brazil). **This trend should, however, change course in 2013, when growth rates are likely to be lower than in 2010-2011, although more sustainable and very close to the potential 4% growth rate for the region overall.** The risks to this scenario include the possible impact from a systemic event in Europe, which would affect the region through increased risk aversion, lower external demand and falling commodity prices.

Among Latin American countries, there are slight downward revisions to GDP growth forecasts compared with the estimates from three months ago. The forecasts for Mexico (3.7% and 3.0%, respectively) remain unchanged in light of the favourable activity figures for the first quarter of 2012, continued favourable financing conditions in the domestic market and increasing competitiveness. In Brazil, by contrast, growth forecasts have been revised downwards (to 2.2% from 3.3% in 2012), because of the impact of the external environment and domestic difficulties as well as a certain deceleration in credit markets and waning competitiveness. Although activity is expected to recover in coming quarters following the adoption of an unprecedented monetary-policy easing, the recent slowdown underscores the doubts on the sustainability of the current growth model and its excessive dependence on private consumption and the growth of lending.

In Asia, and especially in China, stimulus plans are expected to be introduced

For the Asia-Pacific region overall, we expect 5.8% growth in 2013, nearly a half point higher than our forecast for 2012. Nonetheless, this is a downward revision of our previous forecasts, in line with a weaker global outlook. In China, we expect the deceleration to begin to taper off as support policies, especially in terms of fiscal stimulus, increase. Although this stimulus will not be as large as the one introduced in response to the downturn in 2009 (equivalent to more than 10 points of GDP in 2 years), it will be large enough to raise growth. The program is centred on investment-promotion measures: public infrastructure projects, projects to increase productive capacity in some sectors, support for the housing sector and subsidies on purchases of some durable goods. This ensures that **growth rates in China will continue to be at least 7% in 2012-2013.** In addition to the risks from Europe, it is worth emphasizing that there are other (less likely) domestic risks related to: (i) a greater-than-expected adjustment in the real-estate market, which could hinder investment; (ii) an increase in the default rate and financial in stability, and (iii) the policy risk stemming from the handover of power in government. In the rest of Asia, there is also manoeuvring room for economic policies but there are downside risks both of a sharper decline in global demand and of a prolonged deceleration in China that might intensify because of domestic financial weaknesses.

Of the remaining emerging economies, it is worth highlighting the case of Turkey. This country has been under intense pressure in the first half of the year, given its exposure to the eurozone economy. In the first quarter it grew by only two tenths of a percentage point (3.2% yoy vs 5.1% the preceding quarter), and the most recent data do not point to a change of direction. Nevertheless, in the same period, macroecomic imbalances, such as the current account deficit, have corrected strongly. Likewise, inflation has recently improved somewhat more than expected by the authorities, although it remains very high (slightly under 9%). Our scenario forecasts that it will continue to move towards a correction of the strong imbalances (especially of the net trade balance and credit growth) and towards a softer landing than forecast three months ago, with 3.2% growth in 2012 and 4.1% in 2013.

Reversal of outlooks between the two large Latin American economies, Mexico and Brazil

Turning more to a long-term perspective, it is also worth pointing out that doubts are arising on the ability of emerging economies to return to growth rates as high as in the past, once the global economy recovers from the current. Our scenario envisages that emerging economies as a whole will continue to post high growth rates, and that they will continue to be the main drivers of global growth. Nonetheless, **some emerging economies have relied on a growth model based on less sustainable factors, such as higher borrowing.**

Brazil appears to be a case in point. Although the recent stimulus measures (monetary and fiscal) are likely to prove effective in the short term for returning to economic growth, there is a risk that borrowing, is no longer a sustainable support for growth and that it may lead not only to a policy overreaction in order to sustain growth, but also to the possibility of causing overheating and asset-price bubbles.

This contrasts with the performance of the other large Latin American economy, Mexico. Indeed, in recent quarters a change of perception has emerged regarding outlooks for Brazilian and Mexican economies, seen, for example, in a consensus on 2012 growth of 3.8% for Mexico, almost one percentage point higher than the consensus for Brazil. If this is borne out, it would be the second consecutive year in which Mexico has faster growth than Brazil. The strength of its demand—and not necessarily its capacity to supply—and the stronger performance of its trade partners have created better outlooks for Brazil in recent years. Signs of exhaustion of the Brazilian model, which is excessively centred on rising demand, and Mexico's gains in competitiveness vis-à-vis Brazil are helping change the relative outlooks for the two economies, in favour of Mexico.

5. The financial market response to abundant global liquidity and the euro crisis

The uncertain outcome of the euro crisis is exerting downward pressure on rates in risk-free developed countries and boosting capital outflows into Latin America

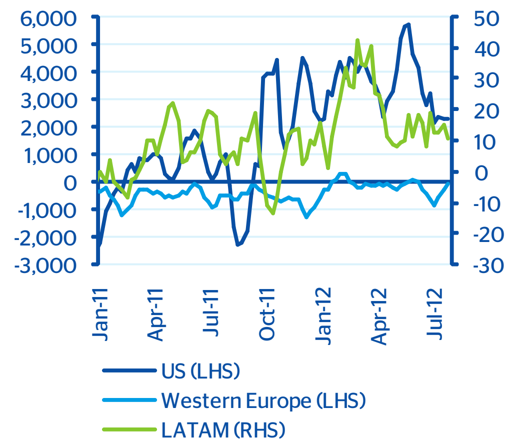
The current global financial scenario is characterised by two elements: i) abundant liquidity and ii) a high degree of uncertainty on the eurozone peripheral countries that are having difficulties in gaining access to the market for financing. The monetary-policy measures undertaken recently by both the US Federal Reserve (Fed) and the European Central Bank (ECB) to reactivate their economies have led to a significant increase in international liquidity. Both institutions have lowered their rates to record levels. In addition, the Fed introduced a significant degree of quantitative easing by purchasing financial assets in order to make sure that long-term interest rates remain low. Liquidity could increase if a new round of monetary stimulus measures is implemented as a result of increasing perception of a slowdown or, in some economies, of a deeper recession. Both the Fed and the ECB remain open to the possibility of taking additional measures, if warranted.

The lack of decisive action by eurozone leaders to solve the crisis continues to fragment the financial market and to make it difficult for some countries to borrow. Investors' uncertainty comes from the perceived misalignment of incentives between domestic and supranational policies to solve the crisis. Nevertheless, these heightened tensions are concentrated in the peripheral countries. In recent months, there has been a change in the perception of which eurozone countries are safer based on investors' assessment of imbalances (fiscal and external) and of the problems arising from the local financial system. Thus, France and Belgium are now considered to be within the group of economies with low (or, in some cases, negative) interest rates on their bonds, alongside with Germany, the Netherlands, Finland and Austria. At the same time, Italy and Spain appear to be joining the group of countries with high spreads on their bonds.

Consequently, in the short term, the scenario of high risk premiums in Europe's periphery, low interest rates in the US and central Europe, and downward pressure on rates in some Latin American countries will remain. Stress in peripheral Europe is exerting downward pressure on long-term rates in the US, in the eurozone core economies, and in some emerging markets, especially in Latin America. Nevertheless, in the first two cases there is little room for rates to fall further, given that they are already very low, while in the latter case, levels are higher and monetary policies could be further eased if necessary. In the short term, this situation will continue, before giving way to a gradual easing of financial stress in the periphery of the eurozone, in keeping with progress in bank oversight, plans for fiscal unity, and greater credibility regarding the implementation of financial-assistance instruments. Consequently, decreasing risk premium in the eurozone should also lead to a gradual increase in these premiums in the United States and in the core economies of the eurozone, until they reach levels that are more consistent with expectations of moderate growth.

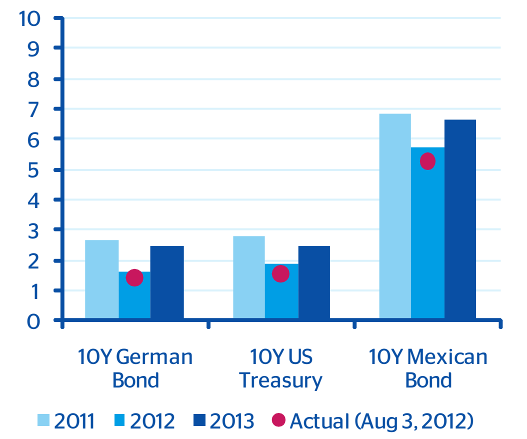
The current scenario favours financial outflows to emerging countries, primarily those in Latin America. This is the result of lower yields in the leading developed-economy debt markets (US and the core countries in the eurozone). At the same time, decreased cyclical strength in the United States (which has become more apparent since May) raises the likelihood of a new round of liquidity increase by the Fed. Hence, the domestic assets of Latin American economies are proving to have interesting traits allowing them to be depositories of portfolio investments. First, potential growth in these countries, in relative terms, allows them to offer higher yields, despite the negative effect from their higher volatility. Second, they exhibit better economic fundamentals, primarily in liquidity and financial-solvency indicators, as a result of the adjustments they were required to make and which led them to a deleveraging phase starting in the late 1990s. In addition, the markets perceive these countries as being less exposed to direct contagion because they are far-removed from the current focus of uncertainty (the eurozone) and as having have greater manoeuvring room in terms of economic policy (fiscal and monetary).

Chart 17
Sovereign debt flows (USD bln)



Source: BBVA Research and EPFR

Chart 18
Long-Term interest rates forecasts (average)



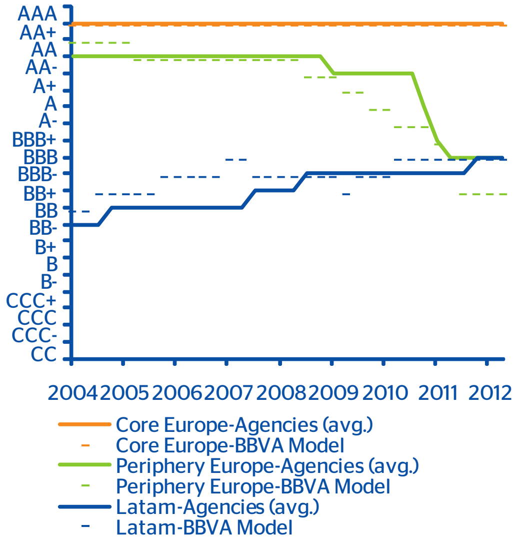
Source: BBVA Research

Nevertheless, investors are unlikely to consider Latin American assets as new safe-haven assets

In this context, we might ask a question as to whether there is a non-transitory change in terms of the character of the sovereign assets of certain regions. Currently, it is more difficult to continue viewing assets previously considered safe, such as those of the eurozone non-core economies, in the same manner, while assets previously considered risky, such as those of some Latin American countries, are now beginning to be perceived as safe-haven assets.

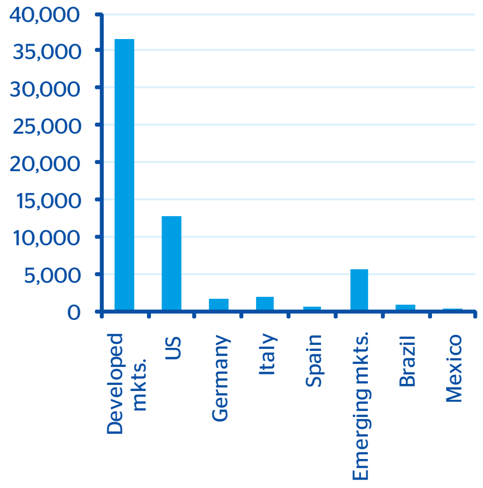
We think that the short answer to that question is no, given that a systemic-risk event would very likely drag down this type of assets. It appears reasonable to assume that a systemic crash entailing a redrawing of the euro area or assistance to some of the peripheral economies would spread to the emerging economies, causing a reversal of capital flows, which would end up being channelled to the United States. The main reasons to think that assets in the emerging economies are not going to be perceived as safe heavens are related to size and volatility. The high growth potential in these small economies and their high capacity to generate fiscal revenues implies that the economic cycle in these economies is more volatile. Their markets are also volatile, because of their shallow financial depth and small market size and liquidity. In a risky situation, these factors make investors more cautious, so that they would favour those assets in big enough economies with no excessive external imbalances, with their own currency, and with a central bank with full capacity to act as a last-resort lender.

Chart 19
Sovereign Rating: Rating Agencies vs. BBVA Model



Source: Standard & Poors, Moody´s, Fitch and BBVA Research

Chart 20
Domestic debt securities issuance, in billions of US dollars



Source: BBVA Research & BIS

6. Tables

Table 1

Macroeconomic Forecasts: Gross Domestic Product

(YoY growth rate)	2009	2010	2011	2012	2013
United States	-3.1	2.4	1.8	2.1	1.8
EMU	-4.4	1.9	1.5	-0.3	0.3
Germany	-5.1	3.6	3.1	0.9	1.4
France	-3.1	1.6	1.7	0.2	0.7
Italy	-5.5	1.8	0.5	-1.8	-0.1
Spain	-3.7	-0.1	0.7	-1.4	-1.4
UK	-4.0	1.8	0.8	-0.4	1.3
Latin America *	-0.6	6.6	4.5	2.9	3.8
Mexico	-6.1	5.4	4.0	3.7	3.0
EAGLES **	4.0	8.4	6.6	5.4	6.1
Turkey	-4.9	9.2	8.5	3.2	4.1
Asia Pacific	4.2	8.1	5.7	5.4	5.8
China	9.2	10.4	9.2	7.8	8.3
Asia (exc. China)	1.0	6.5	3.4	3.8	4.1
World	-0.6	5.1	3.9	3.4	3.7

* Argentina, Brazil, Chile, Colombia, Peru, Venezuela
** Brazil, China, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: August 3, 2012
Source: BBVA Research

Table 2

Macroeconomic Forecasts: Inflation (Avg.)

(YoY growth rate)	2009	2010	2011	2012	2013
United States	-0.4	1.6	3.1	2.0	1.9
EMU	0.3	1.6	2.7	2.3	1.4
Germany	0.2	1.2	2.5	2.0	1.4
France	0.1	1.7	2.3	2.3	1.5
Italy	0.8	1.6	2.9	3.3	1.9
Spain	-0.3	1.8	3.2	2.1	1.5
UK	2.2	3.3	4.5	2.5	2.0
Latin America *	10.6	8.5	9.1	10.1	8.9
Mexico	5.3	4.2	3.4	4.1	3.5
EAGLES **	2.8	5.3	6.0	4.3	4.4
Turkey	6.3	8.6	6.5	8.8	5.3
Asia Pacific	0.3	3.6	4.8	3.3	3.4
China	-0.8	3.3	5.4	3.0	3.6
Asia (exc. China)	1.1	3.8	4.3	3.4	3.2
World	2.2	3.8	5.1	4.2	3.9

* Argentina, Brazil, Chile, Colombia, Peru, Venezuela
** Brazil, China, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: August 3, 2012
Source: BBVA Research

Table 3

Macroeconomic Forecasts: Current Account (% GDP)

	2009	2010	2011	2012	2013
United States	-2.7	-3.1	-3.1	-3.0	-3.1
EMU	-0.3	-0.1	0.0	0.9	1.4
Germany	5.9	6.1	5.8	5.4	5.5
France	-1.5	-1.7	-2.2	-1.9	-1.7
Italy	-2.0	-3.5	-3.2	-2.2	-1.7
Spain	-4.8	-4.5	-3.5	-1.2	0.7
UK	-1.7	-3.3	-1.9	-2.2	-1.3
Latin America *	-0.1	-0.9	-0.8	-1.6	-1.8
Mexico	-0.7	-0.3	-0.8	-1.1	-1.4
EAGLES **	2.6	1.6	0.9	0.5	0.4
Turkey	-2.3	-6.4	-10.0	-7.5	-7.4
Asia Pacific	3.5	3.3	1.8	1.4	1.6
China	5.2	4.0	2.8	2.5	2.8
Asia (exc. China)	2.3	2.0	1.1	0.7	0.9

* Argentina, Brazil, Chile, Colombia, Peru, Venezuela
** Brazil, China, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: August 3, 2012
Source: BBVA Research

Table 4

Macroeconomic Forecasts: Government Deficit (% GDP)

	2009	2010	2011	2012	2013
United States	-9.9	-8.9	-8.7	-7.7	-5.0
EMU	-6.4	-6.2	-4.1	-3.1	-2.3
Germany	-3.2	-4.3	-1.0	-0.6	-0.5
France	-7.6	-7.1	-5.2	-4.6	-3.3
Italy	-5.4	-4.5	-3.8	-1.9	-0.9
Spain	-11.2	-9.3	-8.9	-6.3	-5.0
UK	-11.5	-10.1	-8.2	-8.4	-6.7
Latin America *	-3.1	-2.0	-2.1	-1.8	-1.1
Mexico	-2.6	-3.5	-3.0	-2.7	-2.6
EAGLES **	-3.8	-2.5	-2.3	-2.1	-1.9
Turkey	-5.5	-3.6	-1.4	-1.8	-1.6
Asia Pacific	-4.8	-3.6	-3.7	-3.7	-3.4
China	-2.8	-2.5	-1.1	-1.8	-1.8
Asia (exc. China)	-6.1	-4.5	-5.5	-4.9	-4.4

* Argentina, Brazil, Chile, Colombia, Peru, Venezuela
** Brazil, China, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: August 3, 2012
Source: BBVA Research

Table 5

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

	2009	2010	2011	2012	2013
United States	3.2	3.2	2.8	1.8	2.5
EMU	3.3	2.8	2.6	1.6	2.5

Forecast closing date: August 3, 2012
Source: BBVA Research

Table 6

Macroeconomic Forecasts: Exchange Rates (Avg.)

US Dollar per national currency	2009	2010	2011	2012	2013
United States (EUR per USD)	0.72	0.76	0.72	0.79	0.77
EMU	1.39	1.33	1.39	1.27	1.30
UK	1.56	1.55	1.60	1.58	1.66
China (RMB per USD)	6.83	6.77	6.46	6.31	6.18

Forecast closing date: August 3, 2012
Source: BBVA Research

Table 7

Macroeconomic Forecasts: Official Interest Rates (End period)

	2009	2010	2011	2012	2013
United States	0.25	0.25	0.25	0.25	0.25
EMU	1.00	1.00	1.00	0.75	0.75
China	5.31	5.81	6.56	5.75	6.00

Forecast closing date: August 3, 2012
Source: BBVA Research

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