BBVA | RESEARCH

Economic Outlook

Global

First Quarter 2012
Economic Analysis

- **The global economy is slowing down.** Global growth will only rebound in the second half of 2012, led by the resurgence of emerging economies.
- **Risks to the global outlook are still strongly tilted to the downside,** as the European sovereign, financial and fiscal crisis continues.
- **This crisis has pushed Europe into recession.** Successive EU summits since October and ECB's actions have just bought some time, but major advances have yet to come.
- **Emerging economies are heading for a soft landing,** buttressed by strong domestic demand. Growth is likely to rebound at end-2012, as policies become more growth-supportive.

Index

Closing date: February 9 2012

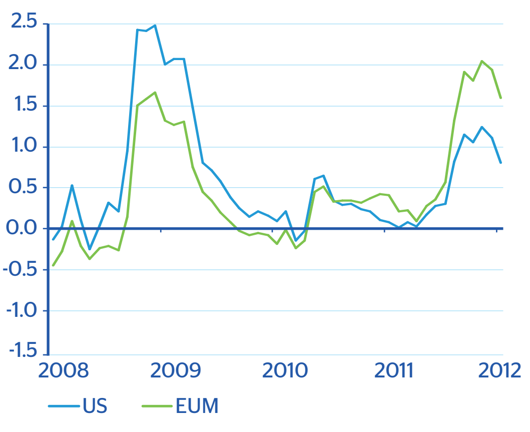
1. Summary: Global slowdown and a recession in Europe

The global economy slowed down at the end of 2011, but will rebound in the second half of 2012, led by emerging economies

The global economy decelerated markedly in the last quarters of 2011. This was the result of weaker growth in Europe (with negative growth already in Q4) and the deceleration in emerging economies, to around 1% quarter-on-quarter at the end of 2011, their lowest growth rate since the 2008 crisis. However, the drivers of this deceleration could not be more different in both areas. Europe is starting to feel the effects of persistently high financial tensions since September (see Chart 1), given the lack of major advances to solve the sovereign and financial crisis. On the other hand, the slowdown in emerging economies, apart from headwinds coming from developed economies, is partly the result of deliberate policy tightening until the first half of 2011, designed to avoid overheating.

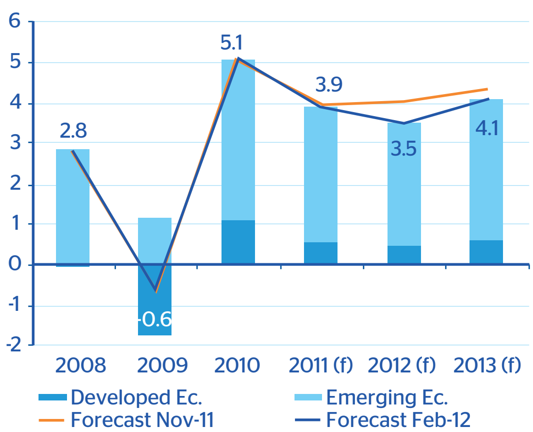
Going forward, we expect decisive action by European authorities that will slowly lower financial tensions in Europe and also global risk aversion, conditioning a global rebound in the second half of 2012. The biggest contribution to that rebound will nonetheless come from emerging economies, as their growth rates recover their historical differential of around 4 percentage points relative to those of developed countries and their policies turn more and more into growth-supportive mode. At the same time, even though the US will grow less than in previous recoveries, it will decouple from the recession in Europe in the first half of the year. Thus, relative to our previous Global Economic Outlook published in November, we are revising down our forecasts for global growth by 0.6pp in 2012 and 0.3pp in 2013, to 3.5% and 4.1%, respectively (Chart 2).

Chart 1
BBVA Financial Stress Index



Source: BBVA Research

Chart 2
Global GDP growth (%yoy)



Source: BBVA Research and IMF

The lack of decisive advances in the resolution of the European crisis makes the euro area still the main risk to the global outlook

Even with the downward revision of growth rates in Europe and emerging countries, we still see risks to the global growth outlook tilted markedly to the downside. These risks continue to hinge on the evolution of the sovereign-financial crisis in Europe, which continues unabated and can potentially deepen the recession there and spill to other regions through trade links, financial exposures and an increase in risk aversion.

Although there have been some advances since October –mainly the provision of long-term liquidity by the ECB and some agreement towards more fiscal discipline– there needs to be more decisive action on the three main lines of action to solve the crisis in Europe. First, on the sovereign debt front, concerns about the solvency of Greece need to be cleared by finishing the deal with private sector bondholders. At the same time, sizable and credible sovereign firewalls must be erected to avoid contagion to illiquid countries. Second, macroeconomic reforms should continue to be pushed forward to increase growth, including those aimed at repairing financial institutions' balance sheets but taking care to avoid a sudden deleverage and a reduction in credit to the private sector. Finally, further advances in euro area governance are necessary to reinforce the monetary union, making it easier to implement sovereign firewalls establishing a clear roadmap to a fiscal union.

In line to these three points, European prospects would be greatly helped if the agreed fiscal compact is finally approved at the national level and rapidly implemented after the March EU summit, together with economic reforms proposed for peripheral countries to reduce their vulnerabilities and increase long-term growth. Rapid implementation of that side of the implicit "grand bargain" between core and peripheral Europe will allow the discussion to pivot to two urgent measures to reduce sovereign stress in Europe. First, rapidly increase the resources available to erect a sovereign firewall around Greece, perhaps with a more decisive action by the ECB; second, take into account the negative effect of a weaker cycle on the ability to meet the agreed deficit targets in most European countries.

Sustained financial tensions have pushed Europe into recession. The growth gap with the US will widen in the next two years

Financial tensions in Europe continue at levels higher than after the fall of Lehman Brothers in 2008 (Chart 1). This, together with the effect of fiscal adjustment in peripheral countries, imply a downward revision of our growth projections for Europe, and we are now expecting negative growth at least in the first half of 2012, and -0.5% for the year as a whole, with a slow rebound in 2013. Nonetheless, it is important to note that these projections depend on a fast resolution of the crisis and a notable reduction of financial stress, to avoid a sharper effect on growth. The different performance between the core and the periphery in Europe will continue to be large, partly because of the large fiscal adjustment in the latter.

Contrary to Europe, the US will show resilience in 2012, as in the second half of 2011. Our forecast remains unchanged from 3 months ago, at 2.3% in 2012 and 2.2% in 2013. However, this recovery is weaker than post-recession cycles, and is surrounded by the risks emanating from Europe and the domestic risk of high policy uncertainty, including a possible massive fiscal tightening in 2013 (as tax cuts expire and automatic spending cuts related to the debt ceiling limit agreement are implemented automatically). In addition, weak housing conditions, tight credit markets and ongoing deleverage will limit the pace of consumption growth. All in all, we see more risks to the downside than to the upside in the US.

Emerging economies are heading for a soft landing, buttressed by strong domestic demand. Policies will become more growth-supportive going forward

One important aspect of the current crisis is that confidence has remained resilient in emerging economies, as opposed to the aftermath of the fall of Lehman Brothers in 2008. One possible determinant of this resilience is the surprising nature of the Lehman fall (mostly absent in the European crisis) and the different speed at which each one develop (the European crisis advancing in "slow motion"). This has allowed domestic demand in emerging economies to hold up well, even as some of the effects of increased global risk aversion are felt in financial markets in the region, through lower capital inflows, some impact on trade finance, reduced asset prices and lower exchange rates.

The slowdown in emerging economies during 2011 meant that their growth gap relative to advanced economies was close to 3 percentage points at the end of 2011, below the historical 4 percentage points seen since the beginning of the 2000's. We expect global risk aversion to remain high, but ease slowly in the second half of 2012, in line with the expected gradual reduction of tensions in Europe. In addition, economic policies will take advantage of existing buffers (including lower inflationary pressures and some fiscal space) and turn more and more into growth-supporting mode, in contrast with the tightening experienced in the first part of 2011. This will allow domestic demand to continue supporting growth in the region, in the face of external headwinds coming from developed countries. In this context, emerging economies are expected to recover growth rates close to 2% quarter-on-quarter at the end of 2012 (from 1% at end-2011), and grow 6.2% for the year as a whole. The main exception to this good performance will be concentrated on emerging countries in Europe, as they will be more affected by closer trade and financial links to the euro area.

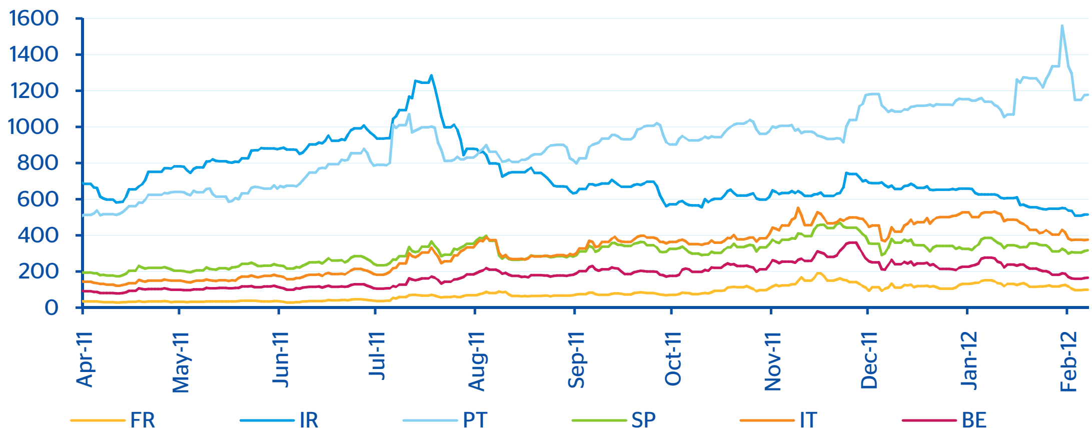
2. The crisis in Europe pushes the region into recession

The European sovereign debt crisis continues unabated. Solutions after the December and January summits have been partial so far

Since last summer, the sovereign debt crisis has become systemic within the euro area. According to our financial stress index, tensions in November reached all-time highs (Chart 1), well above the Lehman episode. Despite some easing in the past few weeks, market conditions are very tight (Chart 3) especially among sovereigns and the banking system.

The approach to solve the sovereign crisis in Europe has been clearly partial and somewhat erratic. As we have mentioned in the past, there are three main fronts where EU authorities need to agree on crucial steps to end the crisis: (i) sovereign debt, (ii) reforms to promote a more balanced growth, and (iii) euro area governance.

Chart 3
10-year bond spreads to Germany (bp)



Source: BBVA Research and Bloomberg

Solvency concerns still need to clear, and a credible firewall for illiquid countries has not been erected yet

The sovereign debt front has two main pillars: dealing with insolvency as well as liquidity problems. Greece's insolvency has been tackled too slowly, and has been probably exacerbated by a rescue programme that was too harsh on fiscal measures and by the Greek authorities' not complying with its conditionality, or at least its implementation. The second bailout programme, which is key for avoiding a default in March, depends on an agreement with the private sector that imposes a haircut of 50% and could entail a net present value loss of 70% or higher. This agreement would still keep open two key uncertainties. First, participation by the private sector may not be large enough. Second, Greece may not be solvent even with full participation given a sharp recession, lack of effective measures and still pending large fiscal adjustments. Participation of the public sector and the ECB in the haircut cannot be ruled out at this point.

For solvent countries with liquidity problems a sizable and credible sovereign firewall must be erected to avoid contagion. In our view, one major mistake (or at least a decision with too many negative externalities) by the EU approach to the crisis was to open the possibility of losses by private sector bondholders through the PSI. The EU agreed in December to drop the requirement that any future rescue by the ESM would necessarily involve the private sector (beyond Greece). This is positive, and is an implicit recognition that the PSI in the Greek case was a mistake, but has not been enough to convince investors that they will not be called upon next time. A clear reflection of this is the widening of Portuguese spreads to all-time highs (Chart 3).

Unfortunately, the intensification of the crisis has rendered all the schemes to leverage the EFSF obsolete, as spreads increased also in core countries in Europe (Chart 3). At the same time, its substitute (the ESM, whose implementation was brought forward to mid-2012) does not change things much, as the amount involved (500 bn Euros) is still not large enough to act as a liquidity "bazooka", and needs to be approved by all countries and implemented. Even adding the extra 150bn Euros approved for the IMF would not be enough to cover the financing needs of Spain and Italy for the next three years. However, a combination of the ESM, EFSF and shoring up the IMF funds within the discussion of the G20 could get closer to nailing it down.

Macroeconomic reforms should continue to be pushed forward, to reduce macroeconomic vulnerabilities and increase long-term growth

Most peripheral countries in Europe have presented some reform proposals and are expected to do continuing doing it shortly (as in the case of Spain). Even though the implementation of those reforms will take time, they are a necessary condition for sustained growth and the long-term survival of the monetary union. Concerns about the strong drag on growth created by large fiscal adjustments are increasingly being put on the table by peripheral countries and the IMF. So far, the response of EU and German authorities to this debate has been vague, pointing only to the possibility of using already available structural funds for this purpose. In our view, these fiscal adjustments should be discussed in the structural-cyclical deficit framework.

One important dimension of much-needed reforms concerns the financial sector. Here, the European Banking Authority increased capital requirements by 2012 as the first response once Spain and Italy were affected by market doubts. But it was the wrong approach in our view. First, it did not deal with the core of the problem in the euro area (mostly sovereign debt, not banking debt), and it did not push for coordinated action on cleaning some euro area banks' balance sheets. Second, applying haircuts to sovereign bonds in the calculation of capital needs increased market concerns on solvency issues, reinforcing the negative feedback running from banks to the sovereign. Lastly, in the context of closed markets for bank funding (which did not open up with these higher capital requirements), forcing a deleveraging without cleaning balance sheets intensified the risk of credit constraints and thus a recession in Europe.

Lastly, advances in euro area governance are essential to reinforce the monetary union

Further advances in euro area governance are necessary to reinforce the monetary union. There have been some advances towards an increased surveillance of macroeconomic imbalances (public and private) in the monetary union, with the agreement of a series of indicators to be closely monitored (the so-called "six pack"). However, there is less progress in other fronts. EU authorities were expected to reach an agreement in December to reinforce fiscal discipline, but the details of the international agreement (excluding the UK and possibly others) were postponed to the March summit, killing hopes of more decisive ECB intervention in bond markets. More importantly, negotiations have not included a clear and credible roadmap to a fiscal union, with Eurobonds at its core.

In a broader sense, rapid advances in euro area governance, including the approval and implementation of the fiscal compact and fast implementation of reforms in peripheral countries would greatly help European prospects. Once that side of the implicit "grand bargain" between core and peripheral Europe is done with, the discussion can then turn to two urgent measures mentioned above to reduce sovereign stress in Europe. First, increase the resources to finance a sovereign firewall around Greece, perhaps with a more decisive action by the ECB. Second, take into account a weaker cycle when evaluating the ability of most European countries to meet the agreed deficit targets.

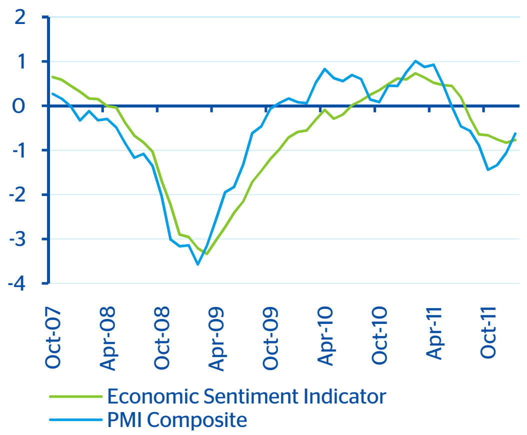
The Eurozone ran out of steam in Q3 and entered recession in Q4. We expect a recession in 2012 and a slow exit in 2013

Unlike what we expected three months ago, measures agreed at the European level in December were not sufficient to mitigate the financial crisis, leading to a very strong drop in confidence (Chart 4) and a sharp increase in financing costs of sovereign debt (Chart 3). This is being accompanied by fiscal consolidation plans for 2012 and 2013 that in some cases fall in the upper range of previous experiences of fiscal consolidations (see Box 1), undermining public consumption. Additionally, the price and quantity restrictions on sovereign funding have been transmitted to the private sector, which is likely to have a strong effect on activity. Eurozone GDP slowed in Q3 and we estimate it contracted in Q4, in both core and peripheral areas, although with marked differences across countries. Confidence has improved in January (especially in Germany), but these positive signs still need to be confirmed in coming months.

Taking into account sustained financial tensions, fiscal consolidation partially offset by a small positive effect from loose monetary policy and a weaker euro, we incorporate a significant downward revision of growth in the next two years. In particular, we forecast a mild recession in 2012 (-0.5%) and a gradual recovery in 2013 (1%, still below its potential). Because of declining activity, the labor market will continue to deteriorate, with an increasing unemployment rate (see Chart 8 in the next section). Large growth differences are expected across countries (Chart 5), given the differing size of their imbalances (unemployment, fiscal deficit or private debt).

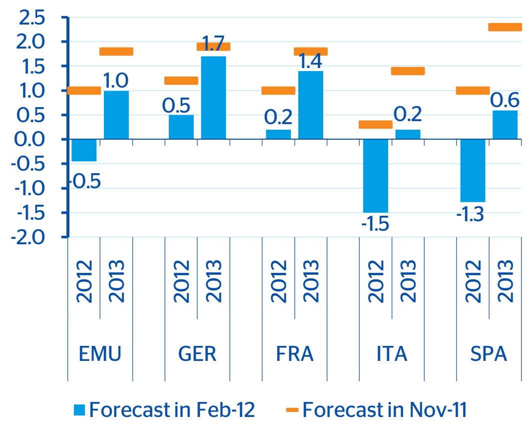
This baseline scenario assumes that the sovereign debt crisis will be tackled in 2012 with a strong firewall to prevent adverse spillovers spreading to rest of member states. Nevertheless, financial strains will only progressively diminish over the second half of the year. Thus, risks around this growth projection are heavily tilted to the downside because of a possible "accident" in the way to a gradual easing of tensions in financial markets.

Chart 4
EMU: confidence indicators (normalized)



Source: BBVA Research, Markit and Have

Chart 5
EMU GDP growth



Source: BBVA Research

The ECB attempts to fix the functioning of European markets, but more is needed

Given the worse outlook for Europe, and absent any significant inflationary pressures, "traditional" monetary policy will remain biased to a more accommodative stance. The ECB has reduced its refinancing rates by 50bp and we foresee an additional 25bp rate cut in the coming months, which will take rates to 0.75%, below the previous 1.0% floor.

Yet we believe that this is not enough to tackle the European crisis. A broader role of the ECB might be needed. Markets are almost closed for financial institutions other than core countries, and conditions for sovereigns, which have been very tight over the last part of 2011, have improved only recently. So far, the support from the ECB to sovereign debt markets (buying bonds through the Securities Market Program) has been limited under the conviction that the ECB's role is not to act as a lender of last resort for sovereigns, but rather to restore the monetary policy transmission mechanism, something that still has not happened.

Instead, the role of the ECB has focused on providing liquidity support to the banking system, which has been seriously hurt. Prolonged sovereign concerns are moving to banking risk because of the regulatory-led high exposure of the banking system to sovereign debt. In addition, this sovereign exposure is negatively affecting the ability of the banking system to access wholesale funding markets (increasing its reliance on the ECB) and fuels concerns about banks' solvency, which in turn has led to new capital requirements for the European banking system.

In order to give support to the banking system, which is facing a very tight schedule of debt maturities at the beginning of 2012, the ECB provided full allotment of liquidity for up to three years (which has been massively used by European banks), and the broadening of the collateral policy. These measures are having positive effects on the European banking system: they act as a support to funding needs, and at the same time, they reduce the liquidity risk of the system. However, there are no signs that institutions are prepared to lend to each other. This extra liquidity has partially helped to ease tensions in sovereign markets, especially in the short end of the curve, but most of it has reverted to the central bank through the deposit facility.

All in all, we think that unless further measures are taken, the approach to indirectly intervene in sovereign markets through liquidity provision to banks will not be enough to reduce long term rates as required, although it has undoubtedly given the countries time to address the challenges. In addition, reopening private funding markets is essential to restoring normal conditions. Given the close links between banks and the sovereign, bold actions should be taken to address the real root of the problem: sovereign debt woes.

Box 1. Past experiences of large fiscal consolidations in developed economies

Many European peripheral countries (including Spain and Italy) are currently implementing ambitious fiscal consolidation programmes for 2012. In line with the objectives set by the European Commission, Spain will have to reduce its public deficit by around 3.8 percentage points of GDP in 2012, and Italy will have to do so by 1.6 pp. Other countries will cut their deficits: Portugal[1] (3.5 pp), Greece (1.2 pp) and Ireland (0.9 pp). Clearly, these are fairly ambitious targets for many of these countries, which prompt us to compare the present situation with past experiences of fiscal consolidation.

Not all past experiences of deficit reduction are comparable with the programmes that will be implemented in Europe in 2012, as fiscal consolidation can be carried out for reasons other than to reduce the deficit. For instance, deficits may be reduced because of an improvement in the economic cycle, or due to a sharp increase in asset prices (e.g. a housing bubble). Alternatively, restrictive fiscal policies may be implemented to prevent an economy from overheating, in which case, the reduction of the deficit is a consequence of these measures, rather than a specific target set by the economic authorities.

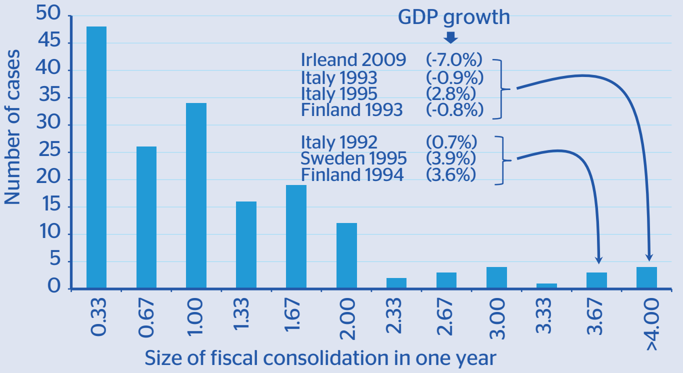
With this in mind, taking as relevant sample a group of 17 OECD member countries[2] for a period between 1978 and 2009, a total of 173 episodes can be observed (country and year) in which the authorities implemented measures aimed specifically at reducing the fiscal deficit.[3] These episodes point to three important conclusions.

Firstly, (see chart 6), consolidations of more than 4% of GDP in one year have only been seen on three occasions: in Ireland in 2009 (4.7% of GDP) and in Italy in 1993 and 1995 (4.5% and 4.2%, respectively). There are five cases of consolidations of more than 3 percentage points of GDP: Finland in 1993 and 1994 (3.7% and 3.5% respectively), Italy in 1992 (3.5%), Sweden in 1995 (3.5%) and the Netherlands in 1983 (3.2%).

Second, even though a deliberate policy to reduce the deficit was in place, in all likelihood, the positive economic environment evident in most cases helped countries meet the targets established by the authorities. Looking at growth rates seen in this period, it is clear that most of the economies grew at an above-average rate compared to previous years, and only three of the eight countries quoted experienced recession. This bears an important relation to the situation currently affecting many European economies, which will not be helped by a growing economy or a positive international environment.

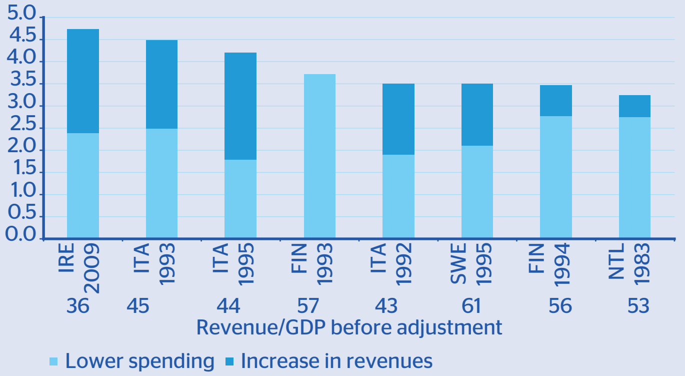
Lastly, a look at how the programmes were carried out tells us that in the eight cases analyzed, 65% of the adjustment was achieved via spending cuts. Specifically, cutting public spending helped reduce the deficit by no more than 2.5 pp of GDP while the rest was achieved by increasing revenues, except when the tax burden was already high, as in Nordic countries (see chart 7), which would have made it difficult to levy further tax increases to meet consolidation targets.

Chart 6
Size distribution of annual fiscal consolidations in OECD countries aimed at reducing the deficit



Based on 173 cases of action-based fiscal consolidation in 1978-2009 for 17 OECD countries (Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, Netherlands, Portugal, Spain, Sweden, UK and US)
Source: BBVA Research based on Devries et al (2011)

Chart 7
Biggest annual fiscal consolidations in OECD, (% of GDP) 1978-2009: decomposition by type of adjustment



Source BBVA Research based on Devries et al (2011)

1: It does not include private banks' pension funds transfered to the State during 2011
2: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, Holland, Portugal, Spain, Sweden, the UK and the USA.
3: "A new action-based dataset of fiscal consolidation"; Devries, Guajardo, Leigh, Pescatori; IMF, June 2011.

3. US stands apart from the global soft patch, but uncertainty is high

Resilient growth is expected going forward, but constrained by euro area weakness and ongoing fiscal drag

The 2012 outlook has slightly brightened after a stream of encouraging data by the end of 2011. New data during the last weeks point to an acceleration of economic activity in the US in the fourth quarter, starting with the first release of GDP figures at the end of January. Industrial production accelerated in December and albeit labor market is limiting the pace of consumer spending, nonfarm payroll growth accelerated for the third consecutive month in January. Accordingly, the unemployment rate fell to 8.3 percent, and continued to trend down (Chart 8). Jobs growth anyway is likely to remain subdued partly reflecting government cuts. In addition, the housing market is beginning to show some signs of improvement except in terms of a still high overhang of foreclosures. These were all positive news for market participants but not enough to reduce market woes questioning whether the US economy can continue in this upbeat vein in the wake of slowing Asian activity and the fallout from a possible intensification of the European crisis (Box 2).

First estimates of GDP growth in the fourth quarter show a 0.7% quarterly increase in economic activity, the strongest rate since a year and half, although with two special factors providing much support: Christmas purchases and inventories. Beyond that, our leading indicators suggest that GDP growth in 1Q12 could be close to 0.5% on a quarterly basis (2% annualized). These trends reflect the ongoing improvement in nonresidential investment, inventories and exports.

Even an annual growth rate of 2.8% in the fourth quarter was below market expectations. Such lower-than-expected estimate is in line with Bernanke's view that the growth outlook is mixed and the recovery not "self-sustained", prompting the Fed to revise down their growth projections for 2012 and 2013. In this sense, we still regard the FOMC's projections of US GDP growth as too high, especially given the fiscal drag from expected future austerity measures.

Albeit the US recovery is weaker than post-recession cycles, it will decouple from the recession expected in Europe in 2012 (see Chart 8 for a reflection of this on the labor market). Relative to our previous Global Economic Outlook published in November, our forecast remains unchanged, at 2.3% in 2012 and 2.2% in 2013.

In our view, risks around this growth outlook are tilted to the downside. The looming crisis in Europe remains the immediate concern in terms of downside risks to growth. In the domestic front, continued weakness in the housing market, tight credit markets and ongoing deleverage will limit the pace of consumption growth. On the policy side, elevated uncertainty (Chart 9) could hold back capital spending and financing. In particular, there is much uncertainty around the possibility of a big fiscal policy tightening in 2013 as a number of tax cuts expire and automatic spending cuts related to the debt ceiling agreement are implemented. VAR estimations show that an increase of 200 points in the index of policy uncertainty may have an impact of up to 2% lower GDP and 13% lower investment after one year[4].

The Fed will keep a cautious stance. Implementing additional stimulus will require a broad consensus even in a more dovish FOMC

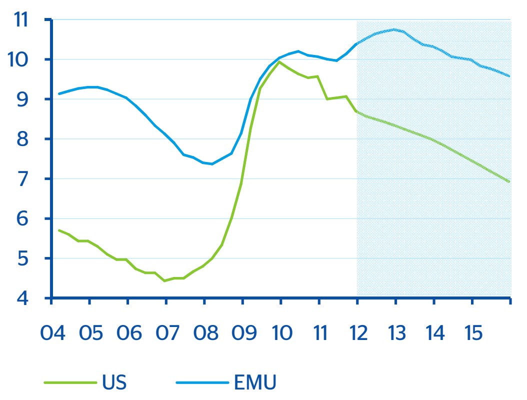
As mentioned above, there are still many mixed signals on the US economy. The Fed, however is prepared to act again if growth projections deteriorate. The recent FOMC statement expressed the committee's desire to remain "highly accommodative". This statement implies that the Fed takes for granted a protracted and very slow recovery even as it forecasts higher growth rates than consensus.

In line with recent projections by FOMC members we expect the Fed to keep interest rates unchanged at least until the beginning of 2014. The Fed's new communication strategy (including the publication of their interest rate forecasts) will try to reinforce their easing stance. The expected effects of the change in communications strategy are: (i) decrease uncertainty about

4: Baker, Bloom and Davis (2011) "Measuring Economic Policy Uncertainty". http://faculty.chicagobooth.edu/steven.davis/pdf/PolicyUncertainty.pdf the future path of the target policy interest rate and reduce interest rate volatility; (ii) help investors make their long-term investment decisions which could be considered as an additional stimulus; and (iii) lower market expectations of long-term rates to boost aggregate demand.

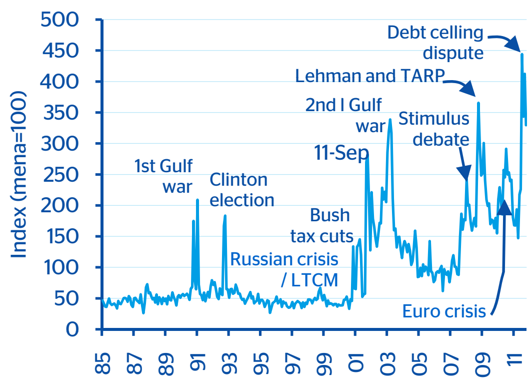
Although another round of asset purchases (QE3) is plausible, it is not imminent. We believe the FOMC is not yet ready to embark on these purchases as its effects will be muted without dealing with the challenges in the housing market. In any case, if conditions deteriorate, the Fed will not hesitate to take more aggressive actions especially in the context of stable inflation expectations.

Chart 8
Unemployment rate in US and EMU (%)



Source: BBVA Research based on Haver Analytics

Chart 9
US: index of economic policy uncertainty



Monthly number of news articles containing "uncertainty" or "uncertain", "economy" or "economic", as well as policy relevant terms ("policy", "tax", "spending", "regulation", "federal reserve", "budget" or "deficit"). Scaled by number of articles containing "today".
Source: BBVA Research based on Baker et al (2011)

Political deadlock will prevent further major fiscal action

Large US structural fiscal deficits and extreme partisanship in Washington are causes for concern. Compared to other regions, in the US the fiscal consolidation process will be much slower, but still subject to abrupt tightening. In the short-term, payroll tax cuts and unemployment benefits that were set to expire in December 2011 ($4tr) have been extended, but only for two months. Although Congress is debating on a 10-month extension, a long-term fix is still pending. Otherwise, the ending of Bush tax cuts as well as payroll tax holiday, together with automatic spending cuts would imply a massive fiscal tightening in 2013.

Congress is likely to agree on extending the payroll tax cut, but the additional economic impact this will carry will be minor. After this agreement, Washington is unlikely to tackle additional issues as politicians focus on the next election due in November, implying political gridlock until then. This leaves the outlook for fiscal policy without a clear and credible plan for fiscal consolidation in the long run, and a likely concentration of fiscal tightening in 2013, precisely the opposite of what would be desirable to ensure a smooth transition to self-sustained growth supported by the private sector.

Box 2. European crisis transmission channels to the US

This box analyzes the possible impact on the US economic growth of a protracted European crisis. Such damage moves along trade, financial and confidence channels. However, a long European crisis can also indirectly impinge US economic growth through declines in equity prices (wealth effects), increasing uncertainty (reducing business confidence) and a global tightening of credit conditions.[5] To measure the impact a prolonged European crisis on US economic activity we focus on two direct linkages: (i) the likely effect on US exports and (ii) on dollar funding conditions in financial markets.

5: For a more detailed outline of crisis channels see our Economic Watch entitled "Crisis Channels: Trade, Financial and Confidence" dated January 19, 2012.

Recent studies have demonstrated a link between financial conditions and the sharp drop-off in world exports following the collapse of Lehman Brothers. Financial crises tend to be associated with capital losses and deleveraging. Naturally, both of these forces restrict the extension of trade credit, which then restricts trade itself. Aside from that, a strong rise in the volatility index – a general sign of poor financial conditions and uncertainty – can trigger another fall-off in US exports, as orders are canceled, firms face payment problems, or currencies fluctuate wildly.

On the other side, research shows that capricious short-selling activity can accelerate a liquidity crisis by producing equity sell-offs. Once short-term funding levels reach a terminal rate, as was the case of 2008, banks decide to hoard cash in anticipation of systemic failure. Thus, extreme liquidity events can disrupt both credit and equity markets. The interconnectivity of financial systems allows for enhanced liquidity, but also generates collateral risk and thus makes dollar funding markets susceptible to volatility swings in other regions and currencies.

To quantify the adverse effect on the US exports of the European crisis we turn to our model of US exports, which incorporates world GDP growth and the volatility index as explanatory factors. Under a hypothetical risk scenario, we use the Federal Reserve's volatility index (risk scenario) from the 2012 Capital Plan Review in conjunction with our own customized adverse scenarios for the US real effective exchange rate[6]. As seen so far, the European crisis has been a long, drawn-out affair, whereas the fall of Lehman Brothers represented a sudden stop to the machinery of international trade. As such, we estimate a more gradual decline of exports than during the Lehman event: US exports would decline by $100bn between 2011Q4 and 2012Q4, which is 0.7% of GDP (See Chart 10).

Turning to the financial system, we think the US banking system could absorb the shock of a European crisis given massive liquidity injections from the Federal Reserve and thorough capital assessment exercises from regulators.

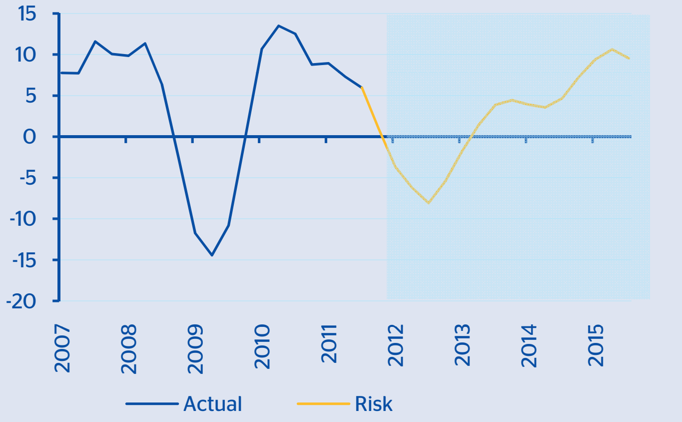
Furthermore, in terms of the potential for financial contagion, one rationale in favor of less drastic pass-through from European crisis is that this issue is already known to the market. The unexpected nature of Lehman Brother's collapse certainly propagated the crisis in 2008, whereas many investors have already pared back their exposure to Europe. Accordingly, the Bank for International Settlements (BIS) reports that the United States' exposure to troubled European countries could total $302.1bn, excluding foreign claims. A major portion of the indirect exposure is related to sovereign and bank (Credit Default Swap) CDS claims: nearly 69% of the United States' exposure is concentrated in derivatives, credit claims, and extended guarantees.

To capture some of the dollar funding dynamics we construct a scenario, which tries to isolate the driving factors of the Lehman event and apply them to a baseline model consistent with the current global economy. Our baseline scenario assumes greater market awareness, thus decreasing collateralized currency funding risk, which results in an average overnight Euro swap spread of 98.2bp – Euribor/Euro Swap- and a more moderate average of 55.7 for dollar swap spreads – LIBOR/US Swap. Under the risk scenario featured by higher volatility, a severe European contraction and deteriorating domestic growth prospects, the Euro and US swap spreads would average 21.5 and 23.3bp above the base scenario (see Chart 11).

In short, the simulation results highlight the significant impact on US growth of a potential worsening European crisis. The total effect on the US economy will depend on the combination of direct and indirect transmission mechanisms and is likely to be sizable but not match the highs of the Lehman Brothers era.

Chart 10

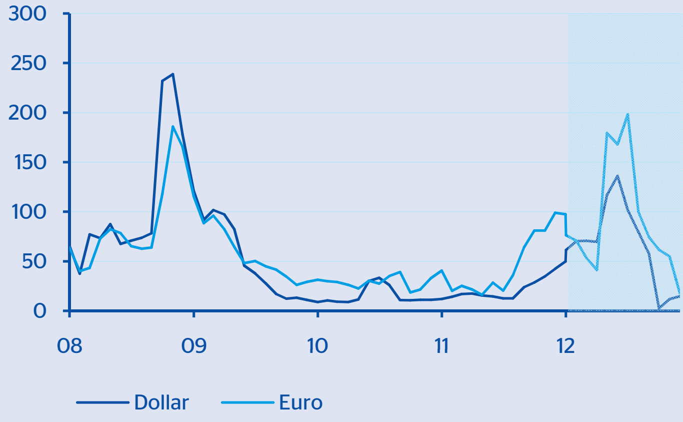
Simulation of US exports under a heightened European crisis (%yoy)



Source: BBVA Research

Chart 11

US and Euro Swap Spreads under a heightened European crisis (bp)



Source: BBVA Research

6: The US real effective exchange rate increases moderately as a result of flight to safety.

4. Emerging economies buttressed by domestic demand

Resilient domestic demand provides a buffer against the global downturn. At the same time, inflation risks abate

Emerging economies lost steam in 2011, as expected, particularly in the latter part of the year. Most saw weaker external demand, as the debt crises in Europe waged on. They were also hit by concerns of a hard landing in China, which have fortunately not materialized. Annualised quarterly growth for emerging-market economies as a whole was still running at an annualised rate of 4% at the end of 2011, although this marks its lowest level since recovery began.

That said, the slowdown in emerging economies is minor considering the plight of the global economy. This is because of the resilience of domestic demand in both emerging Asia and Latin America. Broadly speaking, emerging economies continue to outpace advanced economies. So far, Europe's debt crisis has had a limited impact on these regions, merely causing a slowdown. In countries where imbalances had been built up and were tough to manage through economic policies, this is actually a good thing.

Meanwhile, inflation trends have been mixed. In emerging Asia, inflationary pressures have eased thanks to both the fall in food prices and the slowdown in activity. The outlook is for the downward trend in inflation to continue, as prices of other commodities (mainly crude oil) also decline. In Latin America, inflation has been a touch higher than expected lately in most countries, but should also trend down, albeit not quite as much as in Asia.

Lower inflation and downside risks to prices leave scope for more accommodative monetary policy. In fact that is what we expect: a shift in policy to support, or at least maintain, growth given increased manoeuvrability from the benign inflation outlook as well as the expected slowdown in economic growth. Monetary policy will probably be more accommodative in Asia than Latin America –given a bigger expected decline in headline inflation–, but even there most planned rate hikes have been scrapped and in some cases (e.g. Brazil) there have been cuts.

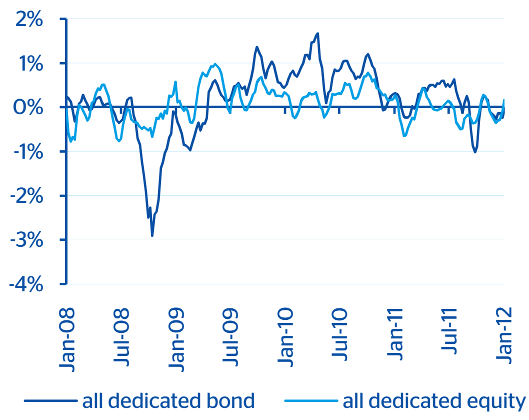
Latin America continues to converge towards potential growth; the region looks in good shape to weather the global downturn

Since the last few months of 2011, economic growth in Latin America has tailed off. This was caused by the spike in inflation, which has eroded purchasing power, and the increase in global risk aversion, which reduced capital inflows (Chart 12), added pressure to currencies, and led to increased uncertainty. Commodity prices, especially copper, were down in the third quarter last year, also affecting the price outlook for 2012. Economies that are more exposed to the global economy (e.g. Mexico) saw their external demands suffer slightly, but not as much as anticipated.

Declines in Latin America were moderate. In certain countries (e.g. Chile or Peru) there are doubts that the slowdown in domestic demand will be enough for inflation to approach central bank target levels. Meanwhile, fixed capital investment remains healthy, driven in part by foreign investment (Chile, Colombia, Peru). This, coupled with expectations of growth in public investment (Brazil, Colombia, Peru), point to continued strong growth in domestic demand, supporting overall activity. In short, Latin America appears to be approaching its potential growth.

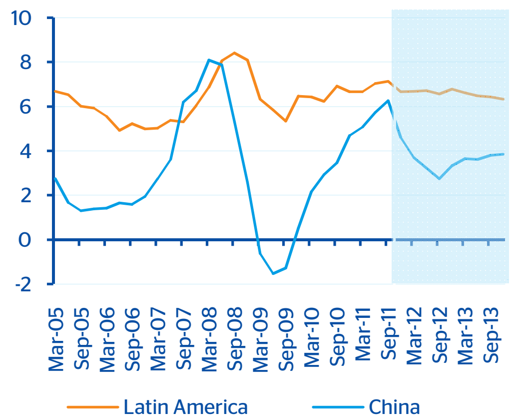
As indicated above, inflation has topped expectations recently. This was partly due to temporary rises in food prices - partially reversed - and depreciation of Latin American currencies in the latter part of the year. Going forward, the combination of falls in food prices and less pressure on domestic demand should help inflation flex down in those countries with official targets (Chart 13).

Chart 12
Flows of funds to emerging economies as percentage assets under management (4 week average)



Source: BBVA Research and EPFR

Chart 13
Inflation (%yoy)



Source: BBVA Research

Latin American currencies have been volatile, moving in line with global risk aversion. Swings were magnified by fluctuations in commodity prices which, while still strong, were also affected by dramatic changes in the global economic outlook. Depreciation through mid 2011 relieved pressure containing capital inflows, with some countries lifting restrictions. However, the global economic slowdown should drive down prices of the main commodity exports in Latin America, while financial markets are likely to remain under pressure, at least in the early part of 2012. In this setting, there should be some depreciation of Latin American currencies.

In this context, growth forecasts have hardly been revised since November (except for Venezuela, where fiscal policy looks set to become more expansive than expected three months ago). Growth in Latin America should remain robust in 2012, albeit with slightly lower growth rates than in 2011, with average growth at 3.7% in 2012 before moving back towards 4% in the next few years. The main driver will be domestic demand, which grew 5.6% in 2011 and is forecast to ease to 4.5% in 2012. External demand should be the main drag compared to last year (Chart 14).

Soft landing in Asia and accommodative policies to spur growth

Trends in Asia remain steady: the global slowdown has caused external demand to lose steam, while domestic demand remains relatively firm. That said, growth has eased only slightly. China is a case in point; GDP growth for the fourth quarter beat expectations (8.9% yoy compared to 9.1% in Q3), underpinned by exports which, while slowing, are still high. This has helped ease fears of a hard landing by the Chinese economy, which would drag down the rest of Asia. Growth in other countries in the region has also slowed down, especially in economies that are smaller and more open to trade.

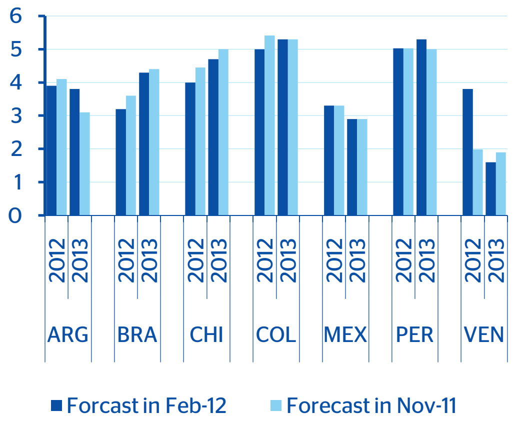
Nonetheless, Asia has not been immune to the effects of the uptick in risk aversion, with markets seeing increases in risk premia and significant capital flight on the back of investors' fear of contagion, albeit less so than in other emerging markets. Against this backdrop, currency markets were hit hard, with across-the-board depreciation in the early part of 2011 – except the renminbi – prompting central bank intervention to relieve pressure, especially in defence of the Indian rupee.

As indicated previously, headline and core inflation eased somewhat, as price declines were driven by food and non-food price easing This fall in inflation helped remove pressure on central banks. Lending growth has slowed, while measures adopted in China to cool down the property market had some success, with prices continuing to trend down.

All this has led to a slight change in the tone of monetary policy, although still high inflation limits authorities' room to manoeuvre. In fact, measures adopted previously in Asia to prevent certain markets from overheating have been put on hold and, in some cases, are starting to be withdrawn. This has clearly been the case of China, where the authorities are now talking of a pro-active fiscal policy. Moreover, at the end of November, China's authorities cut the reserve ratio, sending out a clear message of monetary easing. Other countries, such as Australia and Indonesia, have seen the first interest rate cuts.

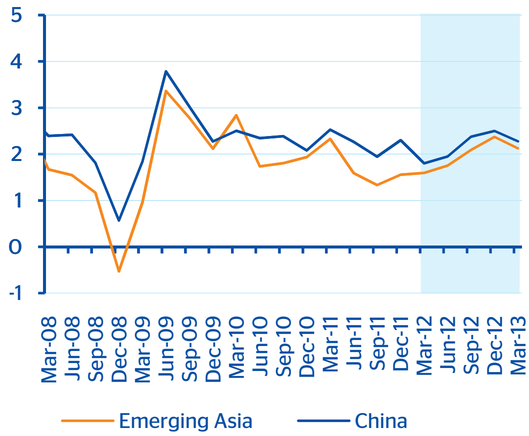
In Asia, growth forecasts have been revised downward a touch. Economic growth will be slower above all in the first half of 2012, before rebounding somewhat in the second (Chart 15) amid a more accommodative economic policy as inflation pressures ease and asset prices fall. As a result, we see scope for (moderate) cuts in interest rates to offset the decline in external demand. In China, growth looks set to be lower than in previous years due to weaker external demand. Even so, GDP still looks set to grow at a heady 8.3%. Inflation should average around 3.3% for the year, with smaller appreciation of the renminbi. As the fall in inflation has given China's authorities greater room to manoeuvre, part of this potential growth could be driven by monetary policy. We expect China to cut rates and the reserve ratio in the first half of 2012 based on trends in foreign demand.

Chart 14
Latam: GDP growth rate



Source: BBVA Research

Chart 15
Emerging Asia GDP growth rate (%qoq)



Source: BBVA Research

Risks are tilted to the downside due to external demand

The risks to this scenario are still tilted to the downside because of both global uncertainties and domestic weaknesses. There are concerns over how much some economic drivers of both regions will slow down: e.g. indications of the scale of the slowdown in China, and the potential impact of the ease in domestic demand in India and Brazil. In China's case, there are also risks from sharp falls in property prices and the financial burden of local corporations. That said, the risk of a hard landing in China, while rising, is still low. Domestic weaknesses are manageable and there is plenty of room for economic policy to support growth.

The same could be said of Latin America. There is sufficient room for policy to tackle the slowdown in external demand. For the most part, budget and current account imbalances are under control, while countries have improved their external positions. Therefore, if the time comes there would be room to support the region's growth. Barring Venezuela, the overall situation in Latin America is solid. The area looks set to continue growing, even if global economic growth falls further.

The impact of lower global growth on both Asia and Latin America should be limited as confidence remains solid and is still far higher than after Lehman Brothers collapsed in 2008. This could partly be because the current crisis is a succession of events more than any sudden or surprising drop. This has enabled domestic demand to be sustained despite the fallout from the increase in risk aversion felt in financial markets through capital flows, lower asset prices and currency depreciation.

5. Tables

Table 1

Macroeconomic Forecasts: Gross Domestic Product

(YoY growth rate)	2009	2010	2011	2012	2013
United States	-3.5	3.0	1.7	2.3	2.2
EMU	-4.2	1.8	1.6	-0.5	1.0
Germany	-5.1	3.6	3.0	0.5	1.7
France	-2.6	1.4	1.6	0.2	1.4
Italy	-5.1	1.4	0.4	-1.5	0.2
Spain	-3.7	-0.1	0.7	-1.3	0.6
UK	-4.4	2.1	0.9	0.5	1.4
Latin America *	-0.6	6.6	4.5	3.7	4.1
Mexico	-6.1	5.4	3.8	3.3	2.9
EAGLES **	4.0	8.4	6.7	5.9	6.5
Turkey	-4.9	9.2	8.5	1.9	4.2
Asia Pacific	4.2	8.1	5.8	5.8	6.1
China	9.2	10.4	9.2	8.3	8.7
Asia (exc. China)	1.0	6.7	3.5	4.2	4.4
World	-0.6	5.1	3.9	3.5	4.1

* Argentina, Brazil, Chile, Colombia, Peru, Venezuela
** Brazil, China, Egypt, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: January 31, 2012
Source: BBVA Research

Table 2

Macroeconomic Forecasts: Inflation (Avg.)

(YoY growth rate)	2009	2010	2011	2012	2013
United States	-0.4	1.6	3.2	2.3	2.3
EMU	0.3	1.6	2.7	1.8	1.3
Germany	0.2	1.2	2.3	1.8	1.3
France	0.1	1.6	2.1	1.6	1.2
Italy	0.8	1.5	2.8	2.2	1.5
Spain	-0.3	1.8	3.2	1.2	1.1
UK	2.2	3.3	4.5	2.8	1.9
Latin America *	6.9	7.4	10.0	9.5	9.1
Mexico	5.3	4.2	3.4	4.0	3.3
EAGLES **	2.8	5.3	6.3	4.8	4.7
Turkey	6.3	8.6	6.7	9.1	6.0
Asia Pacific	0.3	3.6	4.8	3.3	3.4
China	-0.8	3.3	5.4	3.3	3.7
Asia (exc. China)	1.1	3.7	4.4	3.2	3.1
World	2.2	3.5	5.1	3.9	3.6

* Argentina, Brazil, Chile, Colombia, Peru, Venezuela
** Brazil, China, Egypt, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: January 31, 2012
Source: BBVA Research

Table 3

Macroeconomic Forecasts: Current Account (% GDP)

	2009	2010	2011	2012	2013
United States	-2.7	-3.3	-3.2	-3.1	-3.2
EMU	-0.5	-0.5	0.0	-0.1	0.4
Germany	5.6	5.7	5.3	4.6	4.4
France	-1.5	-1.7	5.3	4.6	4.4
Italy	-2.0	-3.5	5.3	4.6	4.4
Spain	-5.2	-4.5	-4.3	-3.5	-1.1
UK	-1.7	-2.5	-2.5	-0.9	-0.2
Latin America *	-0.3	-0.8	-0.6	-2.0	-2.2
Mexico	-0.7	-0.5	-1.0	-1.1	-1.1
EAGLES **	2.4	2.1	1.4	1.2	1.1
Turkey	-2.2	-6.4	-10.2	-8.0	-7.8
Asia Pacific	3.5	3.4	2.5	2.4	2.5
China	5.2	5.2	4.5	4.5	4.5
Asia (exc. China)	2.3	2.2	1.1	1.1	1.2

* Argentina, Brazil, Chile, Colombia, Peru, Venezuela
** Brazil, China, Egypt, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: January 31, 2012
Source: BBVA Research

Table 4

Macroeconomic Forecasts: Government Deficit (% GDP)

	2009	2010	2011	2012	2013
United States	-9.9	-8.9	-8.5	-7.1	-4.6
EMU	-6.4	-6.2	-4.2	-3.0	-2.0
Germany	-3.2	-4.3	-1.2	-0.7	0.0
France	-7.5	-7.1	-5.5	-4.7	-3.4
Italy	-5.4	-4.6	-4.0	-2.4	-1.0
Spain	-11.1	-9.2	-8.2	-5.3	-3.3
UK	-11.5	-10.3	-8.0	-6.4	-4.8
Latin America *	-2.8	-2.0	-1.9	-2.1	-1.4
Mexico	-2.6	-3.5	-3.0	-3.0	-2.8
EAGLES **	-3.9	-2.9	-2.4	-2.6	-2.4
Turkey	-5.5	-3.6	-1.4	-2.0	-1.7
Asia Pacific	-4.8	-3.9	-3.9	-3.7	-3.2
China	-2.8	-2.5	-1.5	-1.8	-1.8
Asia (exc. China)	-6.1	-4.8	-5.5	-5.0	-4.2

* Argentina, Brazil, Chile, Colombia, Peru, Venezuela
** Brazil, China, Egypt, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: January 31, 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	2.3	2.7
EMU	3.3	2.8	2.6	2.2	2.7

Forecast closing date: January 31, 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	0.80	0.79
EMU	1.39	1.33	1.39	1.26	1.27
UK	1.56	1.55	1.60	1.59	1.64
China (RMB per USD)	6.83	6.77	6.46	6.25	5.94

Forecast closing date: January 31, 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	1.10	0.75	0.75
China	5.31	5.81	6.56	6.06	6.56

Forecast closing date: January 31, 2012
Source: BBVA Research

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