

# Economic Outlook

## Global

Second Quarter 2012  
Economic Analysis

- **The global economy will gradually recover in 2012 from the trough in 2011Q4.** The rebound will be most pronounced in Asia. At the other extreme, Europe will undergo a mild recession.
- **Risks to the global outlook are strongly tilted to the downside,** as the European crisis continues. Current oil prices represent only a moderate threat to global growth.
- **There have been some advances to solve the European crisis, but crucial steps are still pending:** a more credible sovereign firewall, a roadmap to a fiscal union and a pro-growth agenda.
- **Emerging economies are on track for a soft landing.** Strong domestic demand will be helped by growth-supportive policies in Asia and high commodity prices in Latin America.

# Index

1. Summary: global recovery, but risks reignite.....	3
2. Europe: still waiting for the solution to the crisis.....	6
Box 1. Advances in European governance since February: fiscal compact and ESM new resources.....	9
3. US: ongoing but fragile recovery.....	10
4. Emerging economies weather external risks.....	12
Box 2: Higher oil prices: a moderate global risk.....	14
5. Tables .....	16

Closing date: May 7, 2012

# 1. Summary: global recovery, but risks reignite

## **Global economic activity will gradually recover, with wider growth differentials across the main areas. But the risks to growth are tilted to the downside**

After a gradual deceleration during 2011, especially in the last quarter, the global economy is starting to show signs of increased dynamism. Global growth in 2012Q1 is expected to have been higher than in Q4, given stronger growth in Asia ex China (including Japan) and Latin America and sustained –but modest– dynamism in the US. We estimate that global growth will continue increasing and surpass 1% quarter-on-quarter at the end of 2012 (0.6% in 2011Q4). This recovery will also be quite heterogeneous, increasing the divergence in growth rates between the main economic areas. The increase in growth in 2012 will be more evident in Asia, given the rebound from natural disasters in Thailand and Japan (affecting regional supply chains) and the partial turnaround of policy tightening measures implemented until mid-2011. Also, growth in Latin America is likely to pick up, as Brazilian growth rates increase on the back of easier monetary policy and Mexico maintains growth over 3.5% helped by US demand, improved competitiveness and supportive funding conditions. On the other hand, the US will continue sustaining quarterly growth rates of around 0.6% in 2012 and 2013, significantly lower than in previous recoveries. Still, this will be better than a basically stagnant activity in the euro-area in 2012, dragged in peripheral countries by aggressive fiscal consolidation and persistently high financial stress, after tensions eased temporarily in the first quarter.

Therefore, emerging economies will recover their growth differential vis-à-vis developed economies, of around 4 percentage points, for the whole of 2012 and 2013. In turn, Europe and the US also will continue to increase their growth gaps in the next two years, even as we expect European authorities to continue taking decisive actions which will slowly lower financial tensions.

All in all, our growth projections are not very different from those of our previous Global Economic Outlook (published in February). We expect global growth of 3.6% in 2012 and 4% in 2013, with emerging economies contributing around 80% of that increase in global activity (Chart 1). But, as mentioned before, this scenario is conditioned on the evolution of the crisis in Europe, and thus risks to these projections are still strongly tilted to the downside.

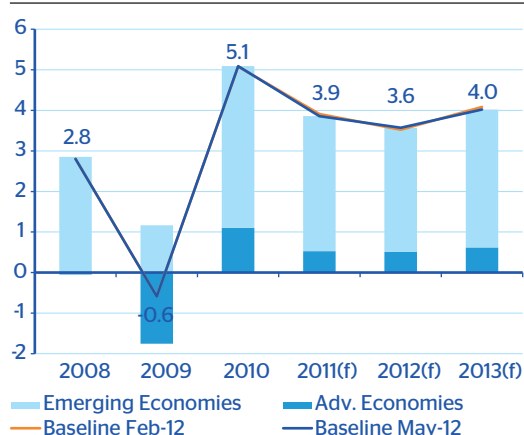
In this context, monetary policies in advanced economies will continue to be very accommodative for an extended period, fulfilling the role of bridging the slump in activity towards the medium and long-run. However, the effectiveness of further intervention (conventional or not) is decreasing, while at the same time the costs increase –including the risk of reduced central bank independence and the collateral damage from unconventional measures–. Thus, it is time for other policymakers and institutions in the US and Europe to decisively take up part of the burden of reviving growth from central banks, implementing economic and institutional reforms and managing fiscal risks. While these measures take effect, central banks should continue supporting an adequate functioning of the monetary transmission mechanism.

Easy monetary policies in advanced economies will mean favourable financing conditions in emerging countries. Here central banks will have to weigh the pressure from capital inflows and an uncertain external demand against inflationary risks (in part from oil prices) and strong domestic demand. The difference in inflation projections in Asia and Latin America –declining in the former but stable in the latter– will condition a different outlook for monetary policies. We expect the easing cycle to have ended in much of emerging Asia (except, notably, in China and India), and a cautious tightening bias in most of Latin America, except in Brazil.

## There have been some advances towards the solution to the European crisis, but crucial steps are still to be taken. Europe needs a clear roadmap to end the crisis

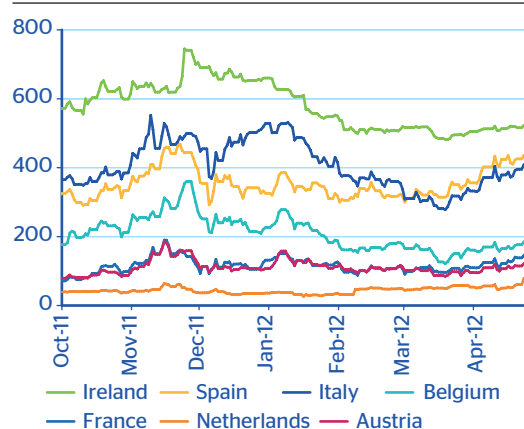
In the last months, there have been some advances towards the solution to the European crisis, but there are still many important pending issues. First, Greek sovereign debt held by the private sector was restructured, although substantial doubts about its long-run sustainability persist, including an unclear majority from recent elections, reform fatigue and a possible deeper recession than projected. Second, the European Stabilization mechanism (ESM) was provided with a fresh lending capacity of 500bn EUR (on top of 200bn already committed by the EFSF). However, that has not been enough to quell market anxiety, given its falling short of Spain and Italy's financing needs for the next 3 years and the presumption that ESM loans would be senior to existing private bondholders, thus seriously impairing its catalytic effect on further financing from the private sector. Further, it was not clear to what extent the increase in IMF resources by 430bn USD (approximately 330 bn EUR) could be targeted to European countries. Third, the fiscal compact was sanctioned (pending national approval), committing governments to structural deficits not bigger than 0.5% of GDP. This is a significant change towards controlling member's budgets, but the allowance for deviations to the rule under "exceptional circumstances" may depict it as not strong enough to justify a more forceful action by hardliners at the ECB of core countries in Europe. In addition, there have been no advances towards a fiscal union or Eurobonds. All in all, a clear roadmap to where Europe is heading continues to be missing.

Chart 1  
Global GDP growth (%qoq)



Source: BBVA Research

Chart 2  
European sovereign risk premia  
(10yr bond spreads to Germany, bps)



Source: Datastream and BBVA Research

## A new flare-up of the European crisis is still the main global risk

Undoubtedly, one of the most important actions in the last four months was the provision of long-term liquidity by the ECB. This allowed, at least until March, a significant reduction in liquidity risk in European banks, a timid opening of wholesale funding markets and a compression of sovereign spreads in peripheral countries (Chart 2). But these positive effects proved temporary, as markets (i) detected some complacency on the part of policymakers as risk premia decreased in the first quarter of 2012, and (ii) they both doubted the ability of many peripheral countries to reach their fiscal targets and feared the fallout on growth of actually achieving them. Thus, since March, risk premia increased rapidly in Italy and Spain, in the latter to levels similar to the high tensions reached back in November (Chart 2).

The short-lived effect of the long-term liquidity injections and the conundrum between fiscal consolidation and restoring growth highlight two conclusions. First, ECB actions can only bridge

the short-run while the underlying economic and institutional problems are tackled. This means that talk of exit strategies for the ECB should not come too soon, but it also implies that economic reforms should be pushed forward, at the same time as demand is rebalanced within the Euro zone, with core countries stimulating it. Second, it is imperative to reconsider fiscal consolidation paths in a coordinated way (to avoid introducing special cases that would be difficult to understand), targeting structural deficits –consistent with the spirit of the fiscal compact– in a more gradual trajectory. In exchange for more gradualism, member states must produce explicit, comprehensive, detailed and multi-annual consolidation plans. This way, sound public finances could be achieved without big damage to short-term growth. At the same time, this will allow to reap the benefits of long-term structural reforms that are being implemented in peripheral countries.

In this context, we still see a new flare-up of the European crisis as the main risk, with potentially very negative consequences for global growth. Increased tensions can come about from reform fatigue in peripheral countries coupled with bailout fatigue in core countries, in the context of electoral processes –and a referendum– in many European countries: a key state in Germany, Ireland and the Netherlands are holding them in the first half of this year, after elections in France, Greece and another German state were held on May 6.

### **Current oil prices will have only a moderate impact on global growth. However, a big oil price spike constitutes a significant risk to growth**

A second threat to the global economy is a further increase in oil prices. The recent spike at the beginning of 2012 can be traced back in part to tightening fundamentals (demand and supply) but also to an increase in the geopolitical risk premium to around 10-15 USD per barrel, given tensions around Iran and very reduced market buffers (oil inventories and producer's spare capacity, see Box 2). In our baseline scenario, we consider prices around 120 USD per barrel of Brent oil for much of 2012, around 20% higher than in our February forecasts. In our view, this will only have a moderate negative impact on global growth, as central banks in advanced countries will view this as a temporary shock and their weak cyclical positions will prevent them from tightening monetary policy, one of the traditional channels of transmission to lower growth. Nevertheless, should the conflict in the Gulf escalate, there could be a very large spike in oil prices, and even if central banks still do not react, growth could be damaged through the associated increase in global risk aversion. We consider that the probability of an escalation in the Gulf is relatively reduced, but it is a scenario that would have a significant impact on global growth should it materialize.

## 2. Europe: still waiting for the solution to the crisis

### Policies implemented since December helped stabilize the euro zone in the first months of 2012

Europe's economic activity clearly declined during the second half of 2011. The sharp increase in financial stress and sovereign debt spreads (Chart 2), falling confidence and global economic slowdown took their toll on economic activity in the euro area as a whole in the fourth quarter. As pointed in our forecasts, these determinants got reflected in a 0.3% quarter-on-quarter fall in GDP, with a slump in domestic demand (-0.6 pp) and stagnant foreign demand, which only contributed positively to growth (+0.3 pp) due to the collapse of imports. Furthermore, this drop in activity was widespread among the member states (except France) while the intensity of the contraction was more pronounced in peripheral countries.

Given the increased uncertainty and risks of an accident in Europe, authorities took a series of measures since the end of the year, which helped stabilize the situation in early 2012, but did not provide a permanent solution to the crisis in the European periphery. On the one hand, the ECB approved in early December the provision of unlimited long-term liquidity in two auctions (LTROs), which took place in December and February, flooding the market with liquidity. At the same time, it expanded the range of assets that can be used as collateral. In addition, the European Union adopted a fiscal compact to strengthen long-term fiscal discipline in member countries and decided to bring forward the implementation of the permanent rescue mechanism (European Stabilization Mechanism, ESM ) and then reinforce it (Box 1). Finally, the European Union had to cope with the worsening of the problems in Greece, and approved, together with the IMF, a second rescue package that incorporates a significant haircut to private bondholders (50% in nominal terms and 74% in net present value) which should, in principle, make Greek public debt sustainable.

This strategy has been complemented by a strengthening of fiscal consolidation and structural reforms in peripheral countries. Other small programme countries (Portugal and Ireland) have generally continued their reform plans successfully and changes of government in Italy and Spain in late 2011 have led to strengthening structural reforms and to take additional steps to meet the fiscal commitments demanded by European institutions.

This strategy has paid off partially, but remains subject to risks and uncertainties.

On the one hand, the ECB's intervention helped to thaw wholesale funding to the banking sector and to ease credit conditions. Data from April's credit conditions survey show that during the first quarter credit supply conditions were less stringent than in the fourth quarter of 2011 (when they were alarmingly tight), but private sector credit in the euro area remains virtually stagnant due to weak demand conditions. The provision of liquidity conditions also led to a fall in sovereign spreads in the first months of the year (Chart 2), largely because the banking systems in the European periphery channeled much of that liquidity to the purchase of domestic sovereign bonds (Chart 3). At the same time, in January confidence recovered together with economic activity.

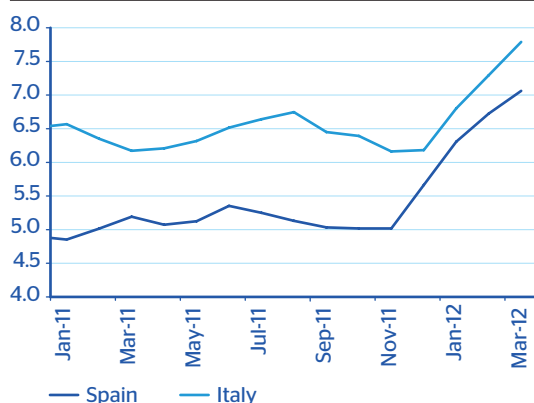
However, as noted in our latest Global Economic Outlook in February, liquidity provision by the ECB was only a temporary response to the crisis in the periphery and provided just a window of opportunity to improve their fundamentals, mainly linked to sovereign debt conditions.

## But there are still crucial steps to be taken towards the solution of the European crisis: we still lack a clear and credible roadmap

In this sense, the aforementioned measures were not sufficient for a lasting calm to markets. First, the second rescue package and debt restructuring in Greece has clarified its financing conditions in the short to medium term and avoided an accident with potential for contagion to the rest of the euro area. But the outlook for the country continues subject to risks that may materialize in the coming quarters as the financing of the second programme remains subject to the conditions imposed by the troika, which will be difficult to implement in a country mired in a deep recession, with a fiscal deficit that is still high and dubious popular and political support for further reforms. Given that the expected path of public debt will remain above 100% until 2030 (Chart 4) these risks fuel doubts about the sustainability of Greek debt.

Chart 3

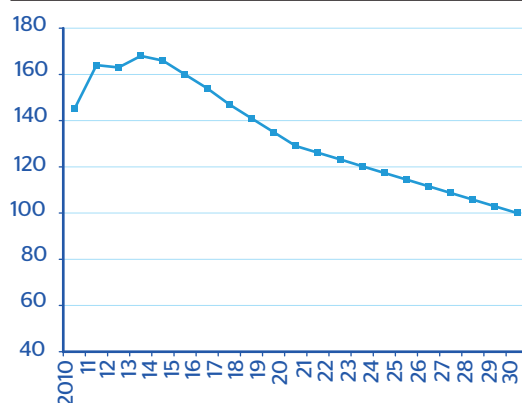
**Banks: Holding of euro area sovereign bonds  
(% of total assets)**



Source: BBVA Research and ECB

Chart 4

**Greek public debt (% of GDP)**



Source: BBVA Research and IMF

Second, the fiscal compact approved by the vast majority of EU countries is subject to implementation risks (referendum in Ireland, the threat of renegotiation by France). Moreover, despite representing a significant shift toward greater control of national budgets, it includes some provisions that allow deviations from the structural deficit limit in exceptional circumstances. The apparent softening of budget rules could depict the fiscal compact as a not being strong enough to justify a more forceful action by Germany or the ECB to solve the crisis. The fiscal compact, on the other hand, contains no elements that suggest a roadmap to a fiscal union that can complement the monetary union and reform programs in the European periphery with some kind of pooling of sovereign debt.

Third, the liquidity firewall approved is greater than that provided through the EFSF, but is far from some of the proposals made by the European Commission. 500 billion euros of new funding (in addition to the 200 mm already committed to existing rescue plans) could be augmented with the new contributions to IMF resources (430 bn dollars, approximately 330 bn euros), but the destiny of these funds will not necessarily be European countries, and its use would be subject to strong conditionality to be determined. Overall, although the liquidity firewall may be sufficient to avoid a possible contagion to Spain or Italy by covering their financing needs, it does not do so convincingly since it does not exceed those needs comfortably (Chart 5) and may be subject to risks of implementation and compliance as experienced in the case of EFSF. Furthermore, the implicit assumption that ESM loans would be senior to existing private bondholders could seriously undermine its catalytic role of increasing sovereign funding by the private sector.

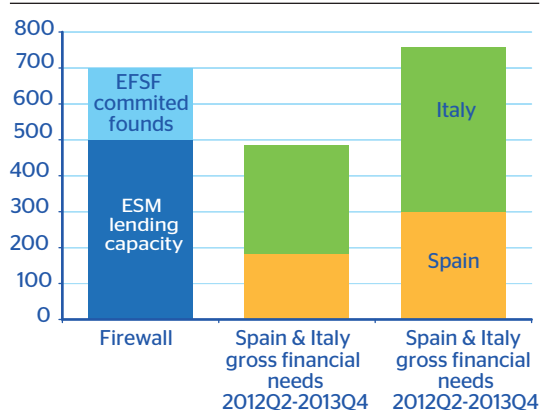
In short, European authorities have not used the window of opportunity given by the ECB's provision of long-term liquidity to finalize a roadmap for a clear and credible solution to the crisis in Europe. Rather, some authorities even sent doubtful signals about the need to continue working on the solution of the crisis given the reduction of tensions in sovereign debt markets.

## Tensions in peripheral Europe resurfaced since March

The result of this process is that, once the short-term effect of the two liquidity auctions evaporated, financial tensions resurfaced, with an increase in Spanish and Italian sovereign spreads (Chart 2), a flight to German public debt (which has seen its long-term interest rates drop to record lows), widespread falls in European stock markets and a reversal in confidence gains seen in the first months of the year. These problems have also been compounded by market doubts about the sustainability of Spanish debt, linked to difficulties to devise and implement specific fiscal consolidation measures at the regional level, and lingering doubts about the Spanish financial system. In addition, there is the growing feeling that the accelerated fiscal consolidation strategy in peripheral countries can lead to a recession that would be difficult to revert in the medium term, threatening the very sustainability of public debt in those countries.

Chart 5

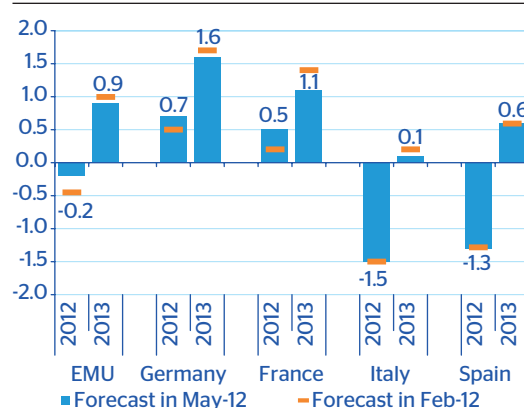
European sovereign firewall and financing needs in Spain and Italy (bn EUR)



Source: BBVA Research and Bloomberg

Chart 6

Growth forecasts in the euro zone



Source: BBVA Research

## We project a mild recession in 2012 and a slow recovery in 2013, with wide heterogeneity and high risks

In short, the available data for the first quarter point to a slight improvement in economic activity due to the rebound in the first part of the quarter, which will not fall as foreseen three months ago. Overall, we do not anticipate an increase in activity until the second half of the year, although it will be very slow at first. For the full year 2012, we expect a slight drop in GDP of -0.2%, slightly better than expected three months ago (-0.5%), as financial strains for the area as a whole are not as negative as they were then. Besides financial problems, fiscal contraction will weigh heavily in the countries of the periphery and, together with higher commodity prices, will drag growth in the euro area. External demand will remain the main driver of growth in Germany and the euro area as a whole, while domestic demand will only accelerate in the core countries of Europe and drop sharply in the countries subject to adjustment. Thus, the growing divergence between center and periphery of Europe will increase over the next two years (Chart 6).

Of course, this scenario assumes that the European authorities continue to take decisive action that will gradually decrease financial stress. Therefore, given the course of events in the past two months, this forecast is subject to strong downside risks, which are at the same time, the main risk factor for the global economy.



## Meanwhile, the ECB will keep an accommodative monetary policy in the euro area, while pressing governments to fulfill their commitments

Regarding interest rates, the ECB incorporated into its communication an upward bias in inflation due to rising oil prices, improving confidence and also lower tensions in debt markets. However, in its latest monetary policy meeting, the ECB reversed this bias given increased tensions in funding markets and lower risks from oil prices. With this background, and under the assumption of a very slow recovery in the second half of the year, we anticipate no change in official interest rates in the forecast horizon. Only if downside risks on activity materialize they would implement a rate cut. As regards the provision of liquidity, we expect at its next meeting in June that the ECB will extend its full allotment for three-month auctions at least until the end of 2012.

The ECB has stopped buying government bonds through the SMP program, but officials insist that the program is still alive. In our opinion, purchases will not be restarted unless there is a substantial deterioration in market conditions. Meanwhile, the ECB continues to press on governments to fulfill their commitments.

### Box 1. Advances in European governance since February: fiscal compact and ESM new resources

#### Fiscal Compact

The fiscal compact was signed by 25 European Union countries (all except the UK and the Czech Republic) in the European summit on 1-2 March. It requires signatory states to incorporate fiscal rules in their legislation (preferably in its constitution) limiting the structural deficit to 0.5% of GDP. The compact has to be ratified before the end of the year and begin to apply from 2016. Temporary deviations from the structural deficit will be accepted under exceptional circumstances, although the definition of "temporary" is not made explicit, and the concept of "exceptional" is relatively lax ("unusual events outside the control of the country", or "severe downturn" without talking about recession).

A deviation from the rule will kick in an automatic correction mechanism, defined by the country in line with the guidelines of the European Commission. If the country does not comply with the plan, it will be referred to the European Court of Justice (this is a novelty), which may impose a fine of up to 0.1% of GDP, which seems low compared with the theoretical fines within the Stability and Growth Pact, which can reach up to 0.5% of GDP.

In addition to the fiscal rule, the summit also approved a provision by which countries with public debt over 60% of GDP will have that ratio decrease at a rate of 1/20th per year, although there are no explicit sanctions to countries that do not comply. On the other hand, sanctions related to the

excessive deficit procedure (which will continue to apply) will be implemented automatically except if a qualified majority of countries oppose it (66% of the vote). To date, sanctions applied only if they were voted by a qualified majority. The new principle is that of reversed qualified majority voting, and greatly reinforces the Stability and Growth Pact.

#### ESM new resources

The March 30 summit officially confirmed the beginning of operations of the European Stability Mechanism (ESM) in July 2012 instead of mid-2013, as decided at the December summit. This mechanism will be permanent and will replace the EFSF, which participated in peripheral countries' rescue plans. ESM funds have increased from a total effective loan capacity of 500 bn euros to 700 bn on a temporary basis, since it can combine the ESM's original 500 bn with the 200 bn already committed by the EFSF in Greece, Portugal and Ireland. The chosen option is the least ambitious of the three proposals by the European Commission which was considering adding (temporarily or permanently) 240 bn of unused lending capacity by the EFSF to the 700 bn described above. The summit also decided to accelerate the payment of ESM capital by countries in four installments through 2014.

### 3. US: ongoing but fragile recovery

#### **Growth in 2012 will be stronger than in 2011, with temporarily higher inflation. But labour market improvement is starting to slow, showing that conditions are not yet back to normal**

The US economy faces an ongoing but fragile recovery. The pace of economic growth in the last quarters is expected to be sustained over the remainder of the year. At the same time, the probability of a double dip has disappeared as most of our monthly activity indices suggest. Nevertheless, signals are still mixed as already stated in our February Global Economic Outlook. In the context of an overall improvement in recent economic data, the US business cycle showed reasonable but slow growth for the first quarter, especially compared with previous recoveries. The first estimate for Q1 quarterly GDP growth came in at 2.2% annualized, driven in large part by 2.9% growth in personal consumption expenditures. The lower-than-expected figure was the result of lower government spending and non-residential fixed investment, which declined 3.0% and 2.1%, respectively. This may be a cautionary reminder that the economy still faces headwinds.

The labour market continues to show a declining (but still high) unemployment rate standing at 8.1% in April (Chart 7). However, nonfarm payroll employment rose by less than expected in March and April, sustaining worries about the strength of the recovery. The fact that the unemployment rate continues to fall even with an unimpressive 2.2% growth rate is troubling evidence that swaths of the working age population are permanently withdrawing from the labour force. Although the US momentum is stable and we expect a slow and gradual increase of GDP growth, it seems too soon to confirm the American business cycle recovery, since some structural problems linger.

On the positive side, profits will remain strong and most recent business confidence indicators continue to recover in manufacturing sectors. However, growth fragility is driven by further deleverage during the next several quarters since mortgage debt will continue to unwind. Additionally, messy foreclosure process, weaker and subdued consumer confidence (evidencing consumers' woes on the notably sharp rise in gas prices, and continued weakness in home prices) and higher political uncertainty –not only related to fiscal consolidation– may slow down growth dynamism.

Albeit the US recovery is significant lower than in previous episodes the growth gap with regard to Europe is widening (Chart 7): the US will continue sustaining quarterly growth rates of around 0.6% in 2012 and 2013. As a result, our growth forecast remains unchanged relative to our previous Global Economic Outlook (published in February): 2.3% in 2012 and 2.2% in 2013.

A limited increase in oil prices will temporarily increase headline inflation but core prices will remain close to the Fed's comfort zone (edging up at a moderate pace). Stable inflation expectations and elevated slack will therefore limit second-round effects.

All in all, in our view tail-risks for US growth are much reduced relative to one year ago, but overall risks are still tilted to the downside. The debt crisis in Europe remains the immediate concern in terms of downside risks not only to the US economy but also to global growth. In addition, the geopolitical risks concerning Iran will add to woes about the recovery of the housing market and the strength of the labour market as the main risks to the US outlook.

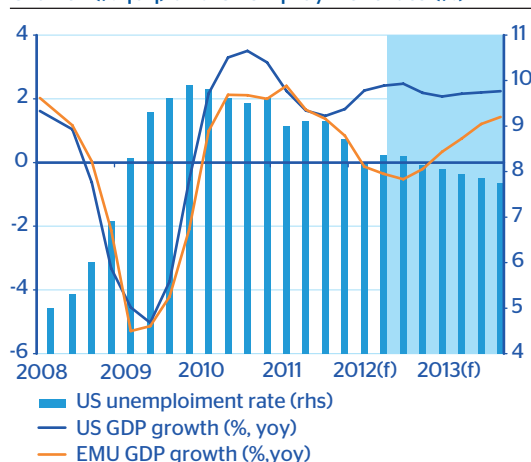
#### **The current recovery reduces the probability of further quantitative easing by the Fed in June. Interest rates will continue to be low for a long time**

Renewed optimism in financial markets has been supported by better-than-expected economic data and some steps towards the solution to the European crisis, even as crucial steps are still to be taken and some peripheral countries suffer yet again from increased market pressure. As a result,

the probability of further easing in terms of additional large-scale asset purchases by the Fed (i.e. QE3) has declined (Chart 8).

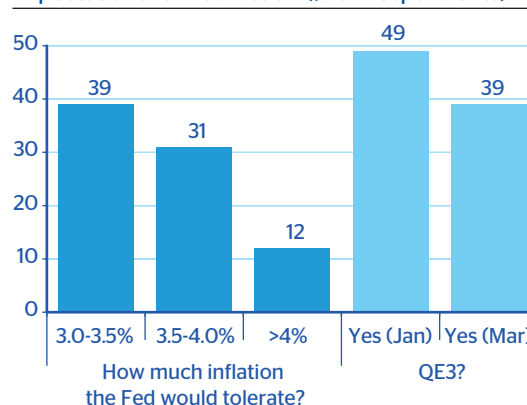
First quarter GDP growth figures support our economic outlook for the year and we do not expect any immediate impact on the Federal Reserve's accommodative stance. Of course, if financial conditions deteriorate or growth is derailed by one of many persistent drags on the economy, quantitative easing remains "on the table" as a policy option. The latest FOMC statement revealed an upgrade to the Fed's 2012 GDP forecast, but a downgrade in the 2013 and 2014 forecasts. Given previously noted downside risks to the growth outlook, conditions still warrant low interest rates for a long period of time.

Chart 7  
**Growth (%qoq) and Unemployment rate (%)**



Fuente: BBVA Research and Haver

Chart 8  
**US: Expectations for Fed Action (% of Respondents)**



Fuente: BBVA Research and Bloomberg

## In the absence of new fiscal measures, consolidation in 2013 will take place at too rapid pace, but still without addressing long-term sustainability

At the end of 2012 tax cuts implemented during the Bush administration (extended two additional years in 2010) are set to expire. At the same time, automatic cuts in public expenditure (social and defense spending) approved in the context of negotiations for the debt limit increase in 2011 will enter into force. Although estimates of the economic impact of this fiscal tightening have a fairly wide range, even in the best case they would be high enough to risk a new recession in the US during 2013.

Although both parties seem ready to let some of the stimulus measures implemented during the Great Depression expire, it seems that neither side is willing to let all of the Bush era tax cuts expire, or to implement all automatic cuts. The congress has the capacity to reverse that agreement but, of course, both parties have different priorities about what kind of expenses should not be cut or what types of taxes should be allowed to increase. So most probably we will have to wait until the outcome of the elections in November to get an idea of how the process will be reversed, and there is even the risk of failure to reach an agreement at least during the first months of 2013 if it turns out that there is a change in president.

In any case, our central scenario points to a gradual fiscal consolidation, which could potentially affect growth slightly in 2013. Perhaps most worrisome is the fact that fiscal consolidation in the long run is not being addressed, even while gaining time with gradual adjustment in the short term.

## 4. Emerging economies weather external risks

### **Despite high uncertainty in the external environment, emerging economies are withstanding the downturn, with only modest impact on their foreign demand**

In the final quarters of 2011, growth in emerging market economies slowed slightly. Nonetheless, these countries have maintained strong growth rates, particularly in light of the past two quarters' sharp deterioration in the international environment. This is a key element shaping the performance of emerging economies. Foreign demand has ebbed significantly in both Latin American and emerging Asian markets due to lower demand from Europe, as the latter region returned to recession and financial market tensions stemming from the public debt crisis flared anew. Additionally, some of the growth slowdown in emerging markets is the result of the early implementation of measures to tighten economic policy amid signs of overheating in 2011. Both factors have been partially offset by the strength of internal demand, enabling these economies to continue their soft landing toward their potential growth rates.

### **Asia's soft landing continues; China eased due to slumping foreign demand, albeit while maintaining high growth rates**

Growth has continued to ease in emerging Asia as a whole, at a pace mostly in line with our previous forecasts. The slowdown is largely attributable to weaker foreign demand, given the slump in economic activity in the region's leading trade partners, particularly lower demand from advanced economies. While eroding foreign trade has affected internal demand, its impact has been contained, and domestic demand remains quite buoyant. Much of the resistance of Asian economies to the international backdrop is due to the limited impact of the European crisis on Asia's financial markets. The region as a whole has also benefited from the continued strength of the Chinese economy (Chart 9). However, China's first-quarter figures were slightly weaker than expected amid shrinking foreign demand. Our estimates indicate that China's slowdown has reached its nadir and that the economy should pick up in the coming quarters. This outlook is consistent with the country's most recently released indicators, which point to improving economic activity.

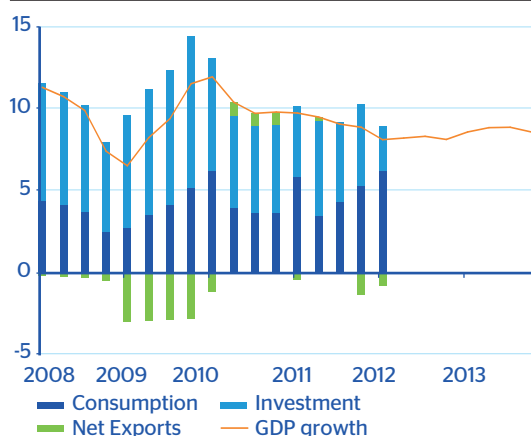
Meanwhile, inflation has trended lower, driven by positive base effects and generalized easing of food prices throughout the region. As for China, monetary and lending aggregates are also slowing, with declining prices of some assets such as housing. These changes mean that overheating risks, which until 2011 were quite substantial, have receded. As for the renminbi, the currency has continued to appreciate in real effective terms, although it has been stable against the US dollar so far this year. With external surpluses narrowing, the authorities have suggested the currency's value is close to equilibrium. That said, we expect some small further appreciation during the second half of 2012.

The combination of a growth slowdown and a fading risk of overheating has prompted authorities to turn to more growth-supportive policies. Interest rates have remained unchanged in China since mid-2011, though the country's two reductions in reserve ratio requirements herald a more expansive phase in monetary policy. Fiscal policy will also be expansive, with a number of additional measures. Chinese authorities have lowered the country's growth target to 7.5%, though this number should be seen more as a lower bound for growth, which has been amply surpassed historically (chart 10). This is likely to happen again given the room for maneuver which fiscal and monetary policies have accumulated in recent quarters.

This greater scope for action on economic policy will avoid the need for major revisions to the region's growth forecasts. Our outlook calls for growth to begin to rebound slightly and offset the first quarter's more tepid performance. Throughout emerging Asia, rising oil prices will have an effect, though growth will still be in the range of 5% in 2012. The Chinese economy is expected to post similar performance, and we maintain our growth forecast at 8.3% this year. Higher oil prices

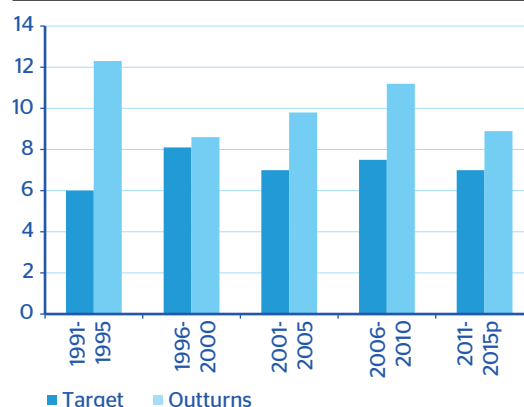
will have a moderate impact on Asian inflation, somewhat greater than forecast until now. Chinese inflation should remain contained, and may end the year on average in the 3.5% range (Chart 11). Inflation has little room to slow further, given the outlook for oil prices..

Chart 9

**China: GDP growth (%yoy) and components**

Source: BBVA Research and CEIC

Chart 10

**Chinese growth: targets and outturns (annual averages)**

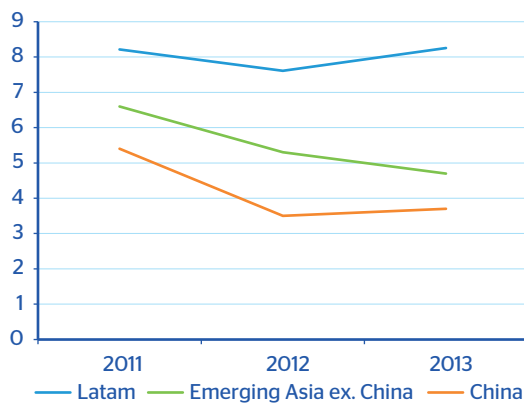
Source: BBVA Research and CEIC

### Latin America's growth forecasts are unchanged: the region is converging towards 4% growth, underpinned by domestic demand, and only inflation partially overshadows the outlook

Very much in keeping with our view on emerging Asia, Latin America has continued to make great gains, though a worsening international environment has dampened growth. High commodity prices have supported the region's economic activity, and the effects of Europe's financial turmoil have been relatively constrained. The region overall has offset weak demand from several countries that are key to trade in the region (Brazil) with demand from booming emerging economies in Asia. Meanwhile, high oil prices are limiting improvements in inflation (Chart 11), but the inflation outlook is still improving on the heels of encouraging data from the beginning of the year. In any event, the prevailing room for maneuver in economic policy is enabling expansive policies in countries in which the slowdown is more severe (as in Brazil).

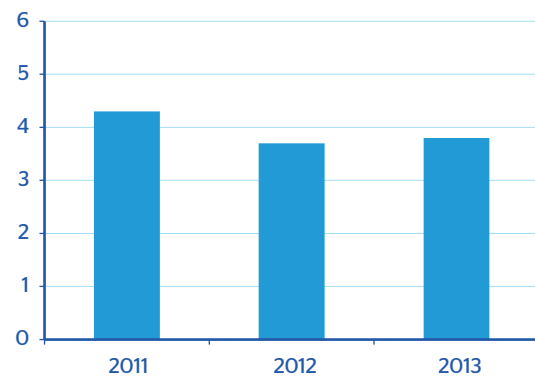
Domestic demand remains buoyant, bolstered by consumer confidence, which is offsetting the impact of foreign demand. Consequently, Latin America's growth outlook is largely unchanged, and in 2012 and subsequent years it will grow by approximately 4%, in keeping with the soft landing scenario forecast for the region as a whole (Chart 12). The region's tradition of stubborn inflation is unlikely to allow substantive improvement against a backdrop of high commodity prices, which will limit expansive economic policies in countries facing inflation challenges. With the exception of Brazil, monetary policy will have a cautiously tightening bias, and forecasts point to strengthening currencies throughout the region.

Chart 11  
Inflation in emerging economies (annual average)



Source: BBVA Research

Chart 12  
Latam: GDP growth (% yoy)

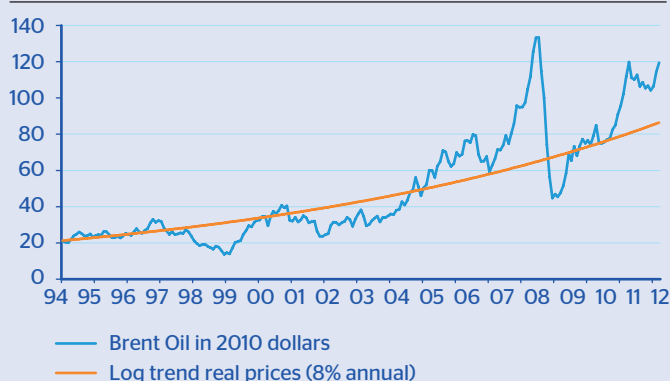


Source: BBVA Research

## Box 2: Higher oil prices: a moderate global risk

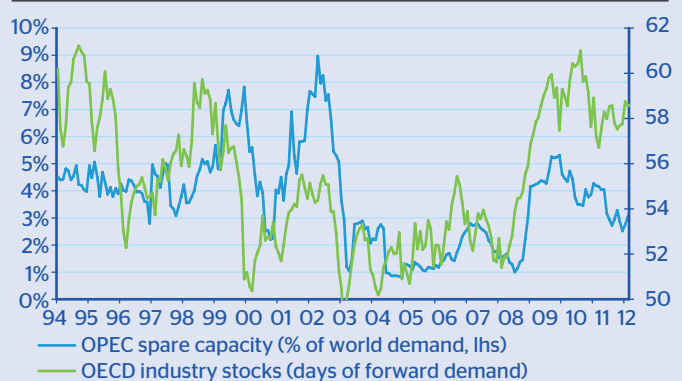
Oil prices have spiked in 2012, dispelling forecasts for a gradual decline this year. In early May, a barrel of Brent oil traded at 120 USD, a level around which it has fluctuated during the first months of 2012. Although these figures are still below the highs reached in dollar terms in 2008 (Chart 13), these highs have already been exceeded in euros or pounds, raising concerns about its impact in some economies.

Chart 13  
Oil prices in real terms (dollars of 2010)



Source: BBVA Research

Chart 14  
Oil market buffers:  
OPEC spare production capacity and OECD inventories



Source: BBVA Research

Part of this unexpected surge in oil prices can be attributed to tightening supply and demand fundamentals. Although the global economy is slowing slightly, emerging economies are showing a great resistance to weaker external environment, offsetting it by the strength of domestic demand. Indeed, changes in market sentiment regarding the recovery in the U.S. or Europe have generated some downward correction in oil prices in early May, which shows the weight of demand as a factor behind price movements.

On the other hand, supply has been affected over recent months due to problems in some key producing areas: social unrest in Yemen and Nigeria, disputes in South Sudan, technical outages in the North Sea, and the embargo imposed on Syria. In addition, Libyan oil has not yet reached the level of production before the civil war.

To these factors, we should add a positive effect on the price resulting from the increased liquidity provided by central banks (especially the two long-term auctions by the ECB).

Moreover, the market has been rocked by geopolitical concerns, resulting from increased tension in Iran which, in an extreme scenario, could shut the transit of oil through the Strait of Hormuz, equivalent to 20% of global oil production and 5% of gas (in particular liquefied gas from Qatar). As a result of rising tensions because of Iran's nuclear program, the EU has banned the import of Iranian oil and the U.S. has imposed restrictions to break ties between Iran's oil revenues and its financial system.

At the same time, traditional buffers to face sharp reductions in supply (crude oil stocks and spare production capacity) are relatively low (Chart 14). OPEC's spare capacity has followed a downward trend in recent years to reach the equivalent of only 3% of world demand, similar to the years before the crisis, characterized by continued increases in prices. If necessary, the U.S. strategic reserves could pump significant quantities, but there is high uncertainty about their ability to do so (between 0.5 and 4 million barrels per day). But even under the best conditions, closing the Strait of Hormuz would leave a gap in the supply of around 10 million barrels a day. On the other hand, stocks in OECD

countries (the only data available) have been significantly reduced from the levels of one or two years ago.

Thus, the hypothetical Iranian ability to close the Strait of Hormuz in retaliation for military action that could be taken against its nuclear facilities combined with very low current buffers have increased the geopolitical risk premium to about 10-15 USD per barrel. This risk premium is likely to continue for most of 2012, so in our baseline scenario we assume oil prices in the vicinity of 120 USD per barrel for most of 2012, representing an increase of 20% compared to our scenario back in February.

Still, these prices will have only a modest impact on global growth, as central banks in advanced economies are likely to treat this as a temporary shock. Also, given the weakness of the cycle and ample slack they are not likely to react with a tightening of monetary policy, one of the traditional transmission channels from an oil shock to lower growth. The possibility that this increase has a significant impact on inflation in emerging economies is also limited, given the widespread subsidies and controlled prices, resulting in a very low pass-through of international to domestic energy prices. However, the effects on growth are more uncertain if geopolitical tensions in the Gulf increase, leading to open conflict. Although it is a very unlikely scenario in the light of ongoing negotiations with Iran, it would trigger a strong rise in oil prices, and although it is unlikely that central banks would react even in this case, growth could be negatively affected by increased global risk aversion triggered by this shock.

## 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	1.9	1.5	-0.2	0.9
Germany	-5.1	3.6	3.1	0.7	1.6
France	-2.6	1.4	1.7	0.5	1.1
Italy	-5.1	1.8	0.5	-1.5	0.1
Spain	-3.7	-0.1	0.7	-1.3	0.6
UK	-4.4	2.1	0.7	0.5	1.4
Latin America *	-0.6	6.6	4.5	3.8	4.1
Mexico	-6.1	5.4	3.9	3.7	3.0
EAGLES **	4.0	8.4	6.7	5.8	6.4
Turkey	-4.9	9.2	8.5	2.7	5.6
Asia Pacific	4.2	8.1	5.7	5.7	6.1
China	9.2	10.4	9.2	8.3	8.7
Asia (exc. China)	1.0	6.6	3.4	4.1	4.4
World	-0.6	5.1	3.9	3.6	4.0

\* Argentina, Brazil, Chile, Colombia, Peru, Venezuela

\*\* Brazil, China, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey

Forecast closing date: April 30, 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	2.5	2.2
EMU	0.3	1.6	2.7	2.4	1.5
Germany	0.2	1.1	2.3	2.0	1.5
France	0.1	1.5	2.1	2.2	1.6
Italy	0.8	1.5	2.8	3.1	1.9
Spain	-0.3	1.8	3.2	1.9	0.7
UK	2.2	3.3	4.5	3.0	1.9
Latin America *	6.9	9.0	10.0	9.3	10.0
Mexico	5.3	4.2	3.4	3.9	3.6
EAGLES **	2.8	5.3	6.3	4.8	4.6
Turkey	6.3	8.6	6.7	9.6	7.1
Asia Pacific	0.3	3.6	4.8	3.5	3.5
China	-0.8	3.3	5.4	3.5	3.8
Asia (exc. China)	1.1	3.7	4.3	3.4	3.2
World	2.2	3.5	5.1	4.4	4.0

\* Argentina, Brazil, Chile, Colombia, Peru, Venezuela

\*\* Brazil, China, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey

Forecast closing date: April 30, 2012

Source: BBVA Research



Table 3

**Macroeconomic Forecasts: Current Account (% GDP)**

	2009	2010	2011	2012	2013
United States	-2.7	-3.3	-3.3	-3.0	-3.3
EMU	-0.5	-0.5	0.0	-0.1	0.4
Germany	5.6	5.7	5.8	5.2	4.9
France	-1.5	-1.7	-2.3	-1.9	-1.5
Italy	-2.0	-3.5	-3.2	-2.2	-1.5
Spain	-4.8	-4.5	-3.5	-1.9	-0.4
UK	-1.7	-3.3	-1.9	-1.7	-1.1
Latin America *	-0.3	-0.8	-0.8	-1.3	-1.9
Mexico	-0.7	-0.3	-0.8	-1.3	-1.4
EAGLES **	2.4	2.0	0.9	0.4	0.5
Turkey	-2.2	-6.4	-10.0	-8.8	-8.5
Asia Pacific	3.5	3.3	2.0	1.5	1.8
China	5.2	5.2	2.8	2.5	2.8
Asia (exc. China)	2.3	2.0	1.4	0.9	1.1

\* Argentina, Brazil, Chile, Colombia, Peru, Venezuela

\*\* Brazil, China, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey

Forecast closing date: April 30, 2012

Source: BBVA Research

Table 4

**Macroeconomic Forecasts: Government Deficit (% GDP)**

	2009	2010	2011	2012	2013
United States	-9.9	-8.9	-8.7	-7.6	-5.0
EMU	-6.4	-6.2	-4.1	-3.0	-2.0
Germany	-3.2	-4.3	-1.0	-0.6	-0.4
France	-7.5	-7.1	-5.2	-4.5	-3.0
Italy	-5.4	-4.5	-3.8	-1.6	-0.5
Spain	-11.2	-9.3	-8.5	-5.3	-3.0
UK	-11.5	-10.1	-8.2	-5.9	-5.8
Latin America *	-2.8	-2.0	-2.0	-1.8	-1.1
Mexico	-2.6	-3.5	-2.8	-2.8	-2.8
EAGLES **	-3.9	-2.5	-2.2	-2.3	-2.1
Turkey	-5.5	-3.6	-1.4	-2.0	-1.7
Asia Pacific	-4.8	-3.7	-3.8	-3.7	-3.2
China	-2.8	-2.5	-1.1	-1.8	-1.8
Asia (exc. China)	-6.1	-4.5	-5.6	-5.0	-4.1

\* Argentina, Brazil, Chile, Colombia, Peru, Venezuela

\*\* Brazil, China, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey

Forecast closing date: April 30, 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	2.6
EMU	3.3	2.8	2.6	2.0	2.7

Forecast closing date: April 30, 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	0.78	0.77
EMU	1.39	1.33	1.39	1.28	1.30
UK	1.56	1.55	1.60	1.60	1.66
China (RMB per USD)	6.83	6.77	6.46	6.25	5.94

Forecast closing date: April 30, 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	1.00	1.00
China	5.31	5.81	6.56	6.06	6.56

Forecast closing date: April 30, 2012

Source: BBVA Research

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