RESEARCH

Weekly Watch
Global

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Economic Analysis

Financial Scenarios
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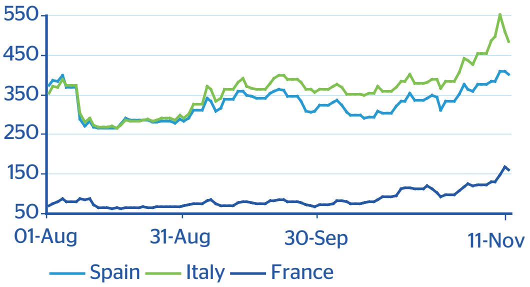
Political Turmoil has increased risk

- **New coalition governments may have limited scope of actions**
  Political turmoil has been in the spotlight in Greece and Italy. Finally, Greece has appointed a new Prime Ministry, Lucas Papademos (a former European Central Bank vice president), the best possible candidate, but the new coalition government has a difficult task ahead to implement reforms as elections will be held very soon, in February 2012. The pressure coming from Europe (and the IMF) remains high, as Greece has to implement measures to ensure the disbursement of the € 8 bn by the troika (to confront debt maturity in mid December) and the approval of the second aid package, including the completion of the PSI. Italy has also been highly affected by political turmoil. The incumbent Italian PM has announced that he will resign after the 2012 budget and structural measures are approved over the weekend, but the final outcome in Italy still remains uncertain. A new (technical) government led by Mr. Monti and supported by most political parties is likely, but there are doubts on the capacity of action of this eventual new government. The resolution of the political crisis in Italy is a necessary condition to avoid a negative scenario, given the size of Italy and its weight in the eurozone. Even considering that Italy's problems are linked to its low potential growth and that Italian debt is sustainable under reasonable assumptions, market concerns will remain. The financial needs of the Italian government are high, amounting to €400bn (excluding short-term debt redemptions) over 2012-13, and the uncertainty persists about the capacity of the EFSF to be adequately leveraged to support Italy. Apart from that, the risk of downgrade of some European triple A sovereigns has increased, and an additional source of concern derives from the proposal by Mekel's CDU party to institutionalize a mechanism for countries to exit the eurozone.

- **A gloomier scenario for European countries, including core countries, while China indicators remain supportive**
  The European Commission has confirmed that growth in the EU has stalled and it will take time to pick up again while China economic indicators support our soft landing scenario. The European commission has downgraded its forecast for the Euro zone 2012 GDP growth to 0.5 percent from 1.8 percent. The main highlight has been the strong downward revision on core European countries. Germany 2012 growth has been revised to 0.8 percent from 1.9 percent and, while French 2012 GDP growth forecast has been cut to 0.6 percent form 2 percent. Meanwhile economic data in China suggest that external demand is weakening, while domestic demand remains strong. Fiscal spending is continuing to support domestic demand. China headline inflation eased in line with our expectations to 5.5 percent y/y from 6.1%. The combination of softer growth and lower inflation monetary policy easing but we do no expect outright shift of the current (tight) monetary stance at this stage. Meanwhile, in the US Jobless claims and trade deficit were lower than expected.

Chart 1
10Y spread vs. German bonds, bp



Source: Datastream and BBVA Research

Table 1
EFSF Issuances face higher cost of funding

Trade Date	Tenor	Mid Swap Spread (bp)	Amount (€bn)	Coupon (%)
25 January 2011	5Y	6	5	2.8
15 June 2011	10Y	17	5	3.4
22 June 2011	5Y	6	3	2.8
7 November 2011	10Y	104	3	3.5

Sources: EFSF and BBVA Research

Economic Analysis

To what extent are market doubts about Italy justified?

We have examined Italian fundamentals vs. those of Spain and of other Eurozone economies. Our conclusion is that, overall, Italy's problems are linked to its low growth potential and, in the short term, the uncertainty over the political outcome, but Italian debt is sustainable under very reasonable assumptions regarding potential growth and primary balance. An additional adjustment in the deficit, likely to be approved today, and ECB support should avoid contagion. This does not imply that the next two years will not be difficult, as deficit reduction will have to be made in a context of very low growth.

Italy's public debt is 120% of 2012 GDP. Nevertheless, Italy's deficit is relatively small, and stands at 4.5% of GDP in 2011. The primary balance in Italy is estimated at +0.8% in 2011, while the structural primary balance (excluding interest payments and adjusting for the economic cycle) stands at +2.1% in Italy. Italian private debt it is much lower than other European Countries. Household debt is 51% of GDP in Italy (62% in Germany and 63% in France). Corporates' bank debt is also lower in Italy (114% of GDP) than in France (154%), but higher than in Germany (99%). External debt is lower in Italy than in most of the Eurozone, but it runs a deficit on current account. Growth potential is lower in Italy than in the other large Eurozone countries. Italy grew by an average of 1.5% in the ten years prior to the crisis, Our latest estimates for potential growth are for 1.2% for Italy (which could rise to 3% if structural reforms are implemented). The reasons for the lower growth potential in Italy are weaker demographics (including a less open attitude towards immigration), together with low productivity growth (shared with Spain). Our estimate for growth potential for the Eurozone as a whole is 1.5%. Our analysis shows that with moderate assumptions (i.e. real growth converging to 1%, inflation at 1.7%, the primary deficit converging to 3%, which implies a total adjustment of 2pp in structural terms, and interest rates of 5%), a debt ratio of 143% of GDP or below that level would be sustainable (i.e. not falling). With interest rates at 7.5% in the long term, the debt would clearly be unsustainable. Italy would require a primary balance of 6.5% to make debt sustainable at those interest rates (i.e. an adjustment of 5.5 pp of GDP).

Can Asia's growth hold up against weakening external demand?

The effects of ongoing global turmoil have resulted in moderating growth momentum in Asia, as we highlight in our latest Asia Outlook for the fourth quarter. So far this year, the region's GDP growth has held up reasonably well, not only in China (9.1% y/y in Q3), but in other large economies such as Indonesia (6.5% y/y in Q3) where domestic demand remains strong. For most of the region, however, especially in the more open and smaller economies such as Hong Kong and Taiwan, the impact on growth of weaker external demand has been more evident. Overall, the region's growth moderation has been healthy so far, as employment conditions are still strong and it has helped ease overheating pressures that had been building in the first half of the year.

As a result of weaker external demand we have made downward revisions to our growth forecasts, with Asia Pacific growth in 2011 and 2012 projected at 5.9% y/y and 6.4% y/y, respectively in 2011 and 2012 (from 6.2% y/y and 6.7% y/y previously). The downward revisions are relatively modest, as our outlook for the region remains positive, with resilient domestic demand and an expected gradual improvement in external demand under our baseline during the course of 2012. However, risks are clearly tilted to the downside. Fortunately, there is room for policy stimulus in most economies. Indeed, several countries have already shifted their policy focus to support for growth, with interest rate cuts in recent days in Australia and Indonesia, and a fiscal stimulus package in the Philippines. Other expansionary policies may be forthcoming if the global environment worsens. The key risk for Asia is a deterioration in the European debt crisis, which could weaken export demand further and cause spill overs to domestic demand. There could also be stresses through financial channels, particularly if capital flows dry up. Ultimately, Asia remains well-positioned due to its strong fundamentals—well capitalized banking systems and high reserve levels in particular--and room for policy stimulus.

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Global Interest Rates

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Markets

Interest Rates: debt markets characterized by volatility and news flow

Over the last week movements in debt markets have been characterized by high volatility, driven by news flow. Following the initial positive reaction to the agreements reached at the summit on 27 October, pessimism returned following the announcement of a referendum in Greece and the political crisis in Italy which led Berlusconi to announce his future resignation once the cuts requested by the EU have been implemented. This situation reached breaking point on Wednesday after LCH raised the margin on Italian bonds, followed by a sharp rise in their yields (around 50bp), which flattened the 2/10Y slope, almost inverting it, as has happened in Greece, Ireland and Portugal. The 10Y Italian bond reached as high as 7.50% with a spread of 550bp versus Germany, extreme levels if we take into account that Portugal and Ireland requested bailouts when their premiums reached 520 and 540 points, respectively. On Thursday, three factors eased this tension considerably: i) Italy issued its targeted amount of 1Y treasury bills; ii) Talk of very active ECB involvement in the SMP programme, and; iii) resolution of the political crisis in Greece, following the announcement that Papademos (former vice-president of the ECB) will be the country's new Prime Minister.

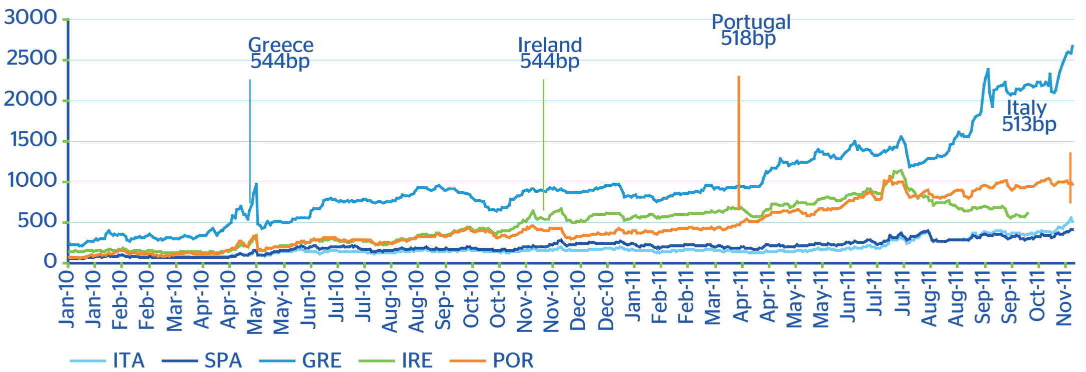
Meanwhile, the German curve is continuing to price in a flight to quality, but with much less brusque movements, since: i) current levels are already very low – the 2Y German sovereign is already at 35bp, with the official ECB rate at 1.25% (in the US the official rate is 0-0.25% and the 2Y is currently at 23bp); ii) Germany continues to stand out from other triple-As – the 10Y France- Germany spread is currently 150bp, a historical high. In the coming days, headlines will continue to drive the markets, although close attention must be paid to the volumes the ECB is purchasing (the last figure revealed a sharp increase on previous purchases) and demand at peripheral countries' auctions.

Credit: heightened political tension has increased volatility in credit markets

The volatility in credit markets caused by increased uncertainty in Italy has driven the Italian risk premium to 550bp, its all-time high. However, at the end of the week, it decreased to 510bp as a result of the ECB purchases and the strong retail demand at the Italian auction on Thursday. In regard to synthetics, the iTraxx indices have widened across the board, with the ITraxx Main widening 15bp to 188bp. In financials, the iTraxx Financial Senior and Subordinate have widened by 41bp and 58bp, respectively, to 286bp and 521bp.

In recent weeks, many European companies have published their third quarter results. European financial entities posted poor results, mainly as a result of the reduction in revenues from trading and the write-downs related to their exposure to sovereign bonds. For example, French banks have taken write-downs on between 50-60% of their exposure to Greek debt.

Chart 2
Rescue Level



Source: Bloomberg and BBVA Research

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Calendar: Indicators

Eurozone: Flash GDP (Q3, November 15th)

Forecast: 0.1% q/q	Consensus: 0.2% q/q	Previous: 0.2% q/q

Comment: We expect quarterly GDP to have grown slightly in Q3, supported by net exports, while domestic demand should have remained very subdued with a flat contribution. Hard data available for that quarter provided positive surprises, painting a less pessimistic outlook than soft indicators already released, that have slumped over Q3. Overall these indicators suggest that economic growth could have been similar to that observed in the previous quarter. Nevertheless, our short-term model for the eurozone foresees flat growth over H2, in line with our baseline scenario, although we see some upside risks for Q3. Across countries, German GDP is likely to have rebounded somewhat stronger than previously anticipated, while activity should have been flat or contracted in the periphery. **Market impact:** A negative figure for growth in Q3 would be very bad received, as it would signal clearly a double dip recession earlier than what some expect (Q4).

Eurozone: HICP inflation (October, November 16th)

Forecast: : 3.0% y/y	Consensus: : 3.0% y/y	Previous: : 3.0% y/y

Comment: We expect inflation to have remained unchanged in October at 3.0% y/y, slightly above our initial projection, driven by higher oil prices than anticipated by end-October. Our forecasts suggest that core inflation is likely to have moderated slightly due to a mild deceleration in prices of non-energy industrial goods. Despite the fact that HICP inflation remained stable, we continue to see inflation to slow down by end year, due to the weakness of domestic demand along with favourable base effects in energy prices, reverting below the ECB target by the beginning of the 2012. **Market Impact:** If the detailed HICP breakdown showed some signs of moderation given the weakness of domestic demand, markets could read as a trigger of a rate cut by the ECB before end-year.

US: Consumer Price Index, Core (October, November 16th)

Forecast: 0.1%, 0.1% m/m	Consensus: 0.0%, 0.1% m/m	Previous: 0.3%, 0.1% m/m

Comment: High food and energy prices have exerted pressure on headline inflation throughout the past few months, however, we expect this trend to moderate in October. Price pressures are slowing, with declines in both import and export prices. While some oil and other commodity price indices increased in October, others declined slightly. Furthermore, slowing demand conditions have eased both input and output prices in the manufacturing sector. Core inflation is also slowing in line with Fed expectations for more stable prices in the coming months. **Market Impact:** While it is not yet clear that the US is safe from troubled waters, moderating price pressures should ease worries for both consumers and producers following months of higher-than-expected inflation.

US: Industrial Production (October, November 16th)

Forecast: 0.2% m/m	Consensus: 0.4% m/m	Previous: 0.2% m/m

Comment: Industrial production is expected to expand again in October due in large part to increasing production in the auto sector. Manufacturing conditions are finally beginning to turn around, with reports of increased shipments and new orders. Although nondurable goods production has declined slightly throughout the past few months, the durable goods component continues to hold strong. The industrial production index is slowly approaching levels seen before the crisis began in 2008, and we expect this trend to continue as the economic recovery gains momentum. **Market Impact:** With much of the focus on the situation in Europe, this report should warrant little market reaction. However, any sign of deteriorating conditions in the US could further global concerns.

Japan: Indicator of the Week: Q3 GDP (November 14th)

Forecast: 1.5% q/q s.a.	Consensus: 1.5% q/q s.a.	Previous: 0.5% q/q s.a.

Comment: As Japan's economy continues to recover from last March's earthquake and tsunami, we expect to see a rebound in Q3 after three consecutive quarters of contraction. In addition to a restoration of supply chains, post-quake reconstruction spending has helped to bolster domestic demand. That said, the recovery faces headwinds from the global downturn, strong yen, and disruptions to Japanese auto and electronics firms from floods in Thailand. **Market impact:** A weaker-than-expected outturn would raise expectations of further quantitative easing and currency intervention by the Bank of Japan.

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Markets Data

			Close	Weekly change	Monthly change	Annual change
Interest Rates (changes in bps)	US	3-month Libor rate	0.46	2	6	17
		2-yr yield	0.23	1	-5	-27
		10-yr yield	2.06	2	-15	-73
	EMU	3-month Euribor rate	1.46	-3	-11	41
		2-yr yield	0.38	-2	-32	-64
		10-yr yield	1.86	4	-33	-65
Exchange Rates (changes in %)	Europe	Dollar-Euro	1.373	-0.4	-0.6	0.5
		Pound-Euro	0.85	-0.6	-2.5	0.8
		Swiss Franc-Euro	1.23	1.2	0.1	-7.8
	America	Argentina (peso-dollar)	4.26	0.2	1.3	7.3
		Brazil (real-dollar)	1.74	0.3	-1.4	1.3
		Colombia (peso-dollar)	1915	0.2	1.0	2.5
		Chile (peso-dollar)	498	0.3	-0.7	3.5
		Mexico (peso-dollar)	13.41	-0.3	1.4	8.7
		Peru (Nuevo sol-dollar)	2.70	-0.2	-0.8	-3.7
	Asia	Japan (Yen-Dollar)	77.09	-1.4	-0.4	-6.6
		Korea (KRW-Dollar)	1126.04	0.9	-3.3	-0.4
		Australia (AUD-Dollar)	1.025	-1.3	0.6	4.1
Comm. (chg %)		Brent oil ($/b)	114.7	2.4	3.0	32.8
		Gold ($/ounce)	1775.5	1.2	5.9	29.7
		Base metals	530.4	0.2	-1.6	-5.8
Stock Markets (changes in %)	Euro	Ibex 35	8555	-0.5	-5.2	-16.4
		EuroStoxx 50	2324	1.4	-2.0	-17.7
	America	USA (S&P 500)	1265	1.0	4.8	5.5
		Argentina (Merval)	2753	-0.3	8.4	-14.4
		Brazil (Bovespa)	58674	0.0	9.0	-16.6
		Colombia (IGBC)	12844	-1.3	-3.3	-15.0
		Chile (IGPA)	20647	0.7	7.6	-10.4
		Mexico (CPI)	37053	1.0	7.5	2.8
		Peru (General Lima)	19294	-0.4	4.0	-4.7
		Venezuela (IBC)	112234	3.6	12.2	69.3
	Asia	Nikkei225	8514	-3.3	-2.6	-12.4
		HSI	19137	-3.6	4.4	-21.0
Credit (changes in bps)	Ind.	Itraxx Main	184	11	12	81
		Itraxx Xover	758	46	16	297
	Sovereign risk	CDS Germany	93	6	3	55
		CDS Portugal	1078	37	-19	627
		CDS Spain	429	41	74	162
		CDS USA	48	1	1	---
		CDS Emerging	302	19	-3	91
		CDS Argentina	927	50	-37	282
		CDS Brazil	159	15	7	55
		CDS Colombia	160	17	6	55
		CDS Chile	128	19	4	53
		CDS Mexico	157	17	8	47
		CDS Peru	162	16	7	46

Source: Bloomberg and Datastream

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