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Global Economic Risk Outlook

1Q20

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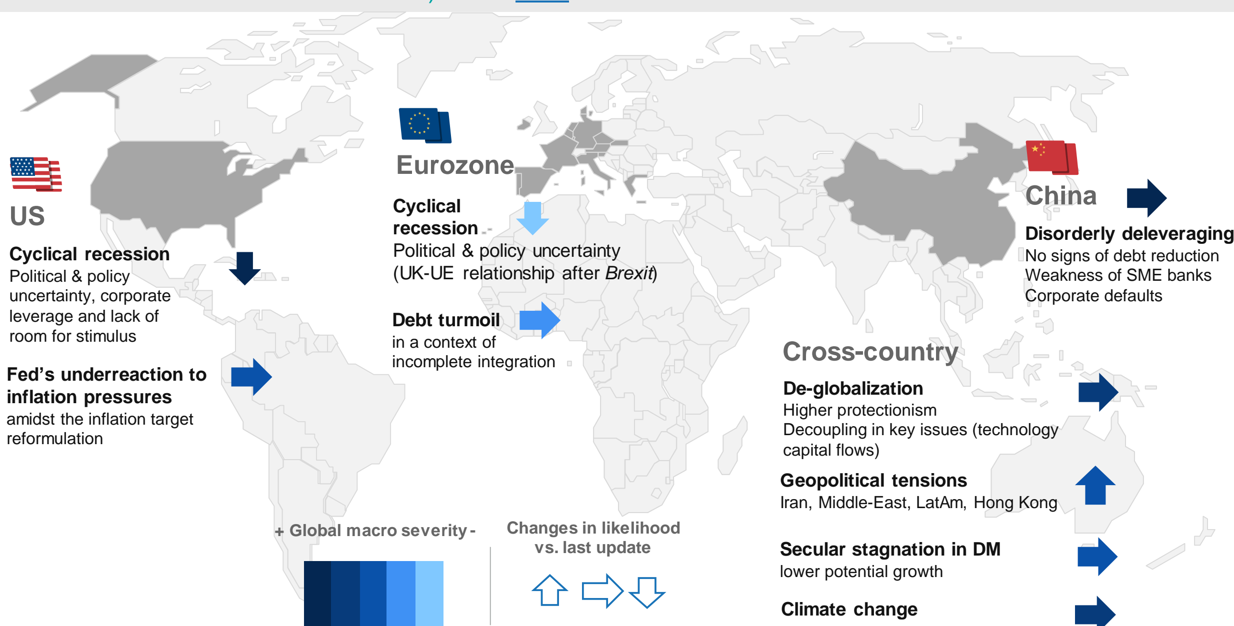
Diminished risks in the short-term but high concerns on structural issues (de-globalization and climate change on the radar)

This report presents an assessment of those global shocks, mostly of low probability, which may have a severe impact on the global economy. Although the flurry of interest rate cuts across the board and the recent easing in trade tensions (‘phase one’ deal between the US and China; USMCA ratification) have reduced the threat of a global recession in the immediate future –important given the low space left for monetary policy and the uncertainty on how quick and where fiscal policy could act-, the **balance of risks remains biased to the downside**:

- in the **short term**, driven by: (i) a **lower but still relevant probability of downturn in the US and the Eurozone**, in a context of growing financial vulnerabilities (corporate leverage, stretched valuations, funding pressure) and high policy uncertainty (trade disputes, presidential elections in the US, EU-UK relationship, political stability in some Eurozone countries), and (ii) **increasing geopolitical tensions** (Middle East);
- in the **medium term**, on the back of a **potential new paradigm in the Sino-American relationship, based on a broader decoupling** in key issues as technology or financial investments (‘de-globalization’ risk). From the trade side, it is worth noting that the ‘phase one’ deal reached between both parties in December neither envisages a significant roll-back of tariffs in place, which will remain high, nor reduces the probability of renewed tensions if each side refuses its commitments (the feasibility of the agreement is under scrutiny);
- also in the medium term, the aftermath of an **inevitable deleveraging process in China remains as a relevant source of concern**. Stimulus implemented to face the effects of the trade war, along with the ongoing economic slowdown, have kept growing the ratio of debt on GDP. Financial pressure on small and medium banks, surge of corporate defaults and rising concerns on credit allocation constitute worrying signals of stress;
- a **secular stagnation in Developed Economies continues to be a structural risk event**. A **debt crisis turmoil in the Eurozone also cannot be ruled out** as long as the fiscal integration remains incomplete;
- in the **longer-term**, costs associated to the transition towards a more environmentally sustainable economy (**‘climate change’**) could trigger a reassessment in asset valuation according to its climate risk exposure.

MAIN GLOBAL MACRO-FINANCIAL RISKS TO THE GLOBAL ECONOMY (SEVERITY IN TERMS OF GLOBAL MACROECONOMIC IMPACT). Click here to see the definition of Fed’s underreaction



Source: BBVA Research

De-globalization risk steaming from broader rivalry among big economies

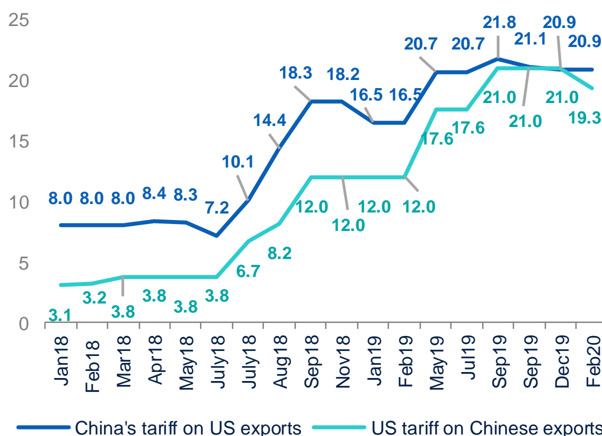
The **new paradigm in the Sino-American relationship**, based on a **broader decoupling in key issues as technology, investment and even financial flows**, may become one of the most relevant risk events for the global economy in the medium term. The **'phase-one' deal** reached in December between the US and China was interpreted as a step in the right direction because it prevented a new round of tariffs which could have driven south financial markets. However, the agreement as currently configured **neither envisages a significant roll-back of tariffs in place, which will remain high** in a new normal way, nor reduces the probability of an escalation of tensions in the near future if each side refuses its commitments or for any other reason.

The **feasibility of the deal** will clearly be under continuous scrutiny, mainly as it seems implausible that China will be able to double its volume of imports to the US over the next two years. Diversion forces (imports substitution) and competitive strategies adopted by other countries to gain market share in the US could entail economic distortions across the board. Managed trade among open markets is a tricky issue. Although the focus is made on the disruptive effects of tariffs hikes, it is also relevant to mention the increase in policy interventions through subsidies as a driver of lower trade liberalization (Evenett, S. and Fritz, J., 2019).

The **crisis of the WTO**, which has received a new blow when its appellate body ceased to function due to the US block to new appointments, reveals the loss of status of the multilateral trade system. The proliferation of bilateral trade agreements has been the partial and imperfect solution that economic areas as the EU have implemented to safeguard trade relations with countries benefited by most-favoured-nation principle under the WTO. Without the participation of the US, a reform oriented to reactivate the WTO role is unlikely to be effective.

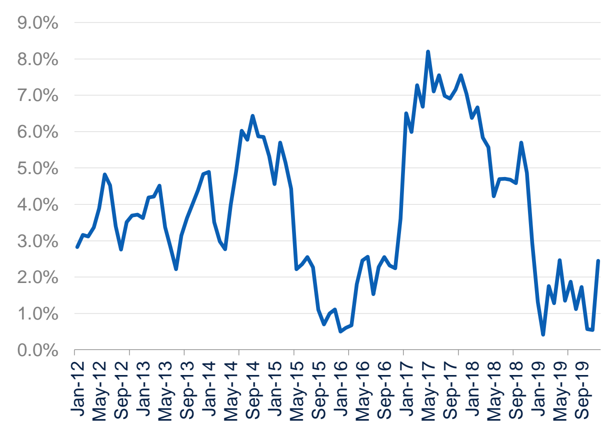
Beyond tit-for-tat trade disputes, the **main source of concern for the global stability** lies on the **rise of a secular de-globalization trend**, characterized by a prolonged and deep breakdown in cross-border economic and financial relations. The **technological sector** is **in the center of the stage**, with China seeking autonomy in fields as 5G, artificial intelligence or automation, and the US restricting the presence of Chinese tech companies in its territory. More importantly, the willingness to move toward greater 'decoupling' is not only shared by the Trump administration; this idea is gaining ground in both sides of the US political arena. Europe is also moving on stricter screening of foreign investments from China, alleging competitive advantages from government aids in the acquisition of European tech companies. Hence, strategic rivalry seems to outweigh economic cooperation among big economic blocks. Trade, investment, currency and geopolitical tensions threat to emerge if this new global order prevails; the **disruptive impact on supply chains and financial capital flows may be severe and lasting**.

AVERAGE TARIFF IMPOSED BY THE US AND CHINA AFTER 'PHASE ONE' DEAL (%)



Source: BBVA Research based on PIIE data

WORLD TRADE OF GOODS (BBVA RESEARCH INDICATOR, YoY CHANGE, 3M AVERAGE)



Source: BBVA Research, Haver

Eurozone crisis amidst low growth and high uncertainty on economic policy

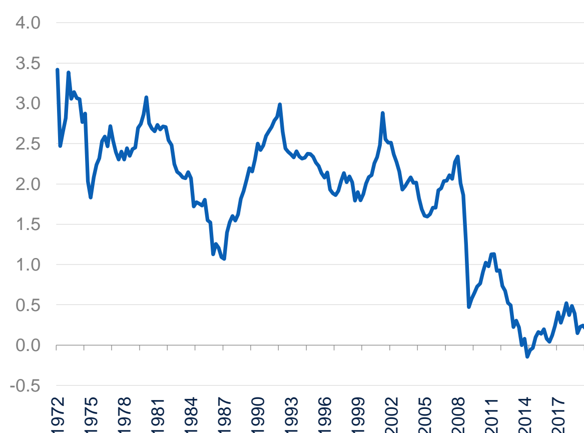
The environment of negative interest rates (driver of 'search for yield' strategies) and the role played by the ECB as debt holder have significantly reduced the likelihood of a resurgence of tensions in sovereign debt markets. With borrowing costs at minimum levels, the fall in interest bills has alleviated the pressure on public accounts (mainly, in peripheral economies) on the assumption that as long as income growth exceeds the paid interest rate on the stock of debt, the public debt ratio to GDP will fall over time (lower risk of debt unsustainability).

The main risk for the Eurozone lies on a **secular stagnation**. Structural factors behind a scenario of low growth and inflation are well-known (ageing, higher risk aversion after the sovereign crisis, public imbalances, low productivity, financial fragmentation across countries, etc.), but the emergence of other recessionary forces affecting simultaneously to peripheral and core countries could trigger a scenario of stagnation if doubts about the commitment to the EU arise. An example is issues arising from **political instability**; the loss of ground by center parties is a reality in peripheral countries but also possible in countries such as France or Germany.

Protectionist threats remain also on the radar. Although higher tariffs on autos are not under discussion yet, punitive decisions on this sector cannot be discarded. In fact, the resilience to the automotive sector to global manufacturing woes and new regulations to cut CO2 emissions constitutes a very relevant source of uncertainty. The **transition towards a more environmentally sustainable economy** (cleaner cars, for example) will likely entail economic losses for those sectors more dependent on fossil resources (carbon) in absence of compensatory mechanisms. As regards ***Brexit***, the new relationship that the EU gets to establish with the UK after 2020 is also determinant to prevent economic disruptions on the Single Market. The most positive outcome would be a step-by-step approach (tariff-free trade in goods to be agreed firstly, and negotiations on financial services and primary sector to be deferred to 2021 and beyond), but less favorable scenarios are still on the table, from bounded agreements on trade of goods to a more disorderly process if the Eurosceptic wing imposes its position.

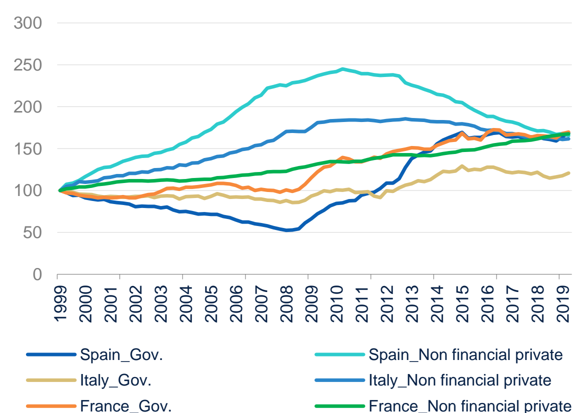
As long as the Eurozone's foundations remain incomplete, the **social and political effects of insufficiently inclusive growth** could reverberate across the block, rising financial instability concerns and keeping alive the risk of a new debt crisis in the medium term. The **lack of enough monetary munition** to refloat the economic cycle (pending on the 'strategic review' of the ECB policy, including a potential redefinition of inflation target), along with constraints to adopt an ambitious program of fiscal stimulus by those countries with large space to do it, could intensify macroeconomic effects of a potential economic downturn. Under an adverse scenario in the Eurozone, the main channel of global contagion would arise from an increase in financial volatility. Global trade and commodity prices would see a reduction due to subdued demand growth from the block.

NATURAL INTEREST RATE FOR EUROZONE (%)
HOLSTON-LAUBACH-WILLIAMS ESTIMATION



Source: BBVA Research, New York Fed

DEBT IN EUROZONE COUNTRIES
(100=1Q99)



Source: BBVA Research, BIS

US recession amid high policy uncertainty and private sector vulnerabilities

'Recession risk' has fallen to its lowest level since December 2018 according to probability models based on financial market metrics[1]. The Fed's 'mild-easing' cycle has cushioned the deterioration in growth expectations, reverting the inversion of the yield curve and contributing to the bottoming out of confidence indicators. However, the divergence between the contraction of fixed investment and the resilience of private consumption (still supported by the strong job creation[2] and solid household finances[3] but exhibiting signs of moderation) reveals that although the expansionary phase could prolong a little more, the **downside risks** on the US economy **remain**.

Among the main sources of concern, it is worth noting the **high degree of economic policy uncertainty** from both the domestic (elections in 2020 and the agenda of next President on international strategy, fiscal policy and regulation) and the external side. The persistence of **trade frictions** and the impact of tariffs (lower corporate margins and/or consumption) threat to undermine the domestic demand in next quarters. **Corporate indebtedness** also continues to be a source of potential instability. High corporate debt coexists with (i) **a worsening of credit standards**, mainly among SMEs (the share of speculative-grade on total corporate debt is nearly 50% of total while the debt-at-risk surpasses 25%), (ii) the expansion of leverage funding (it represents a growing share of the new issue market, with nonbanking lending increasing faster than banking loans), (iii) the rise of financial risk-taking strategies (dividend payments, share buybacks and M&A, funded with debt) and (iv) **earnings slowdown.**

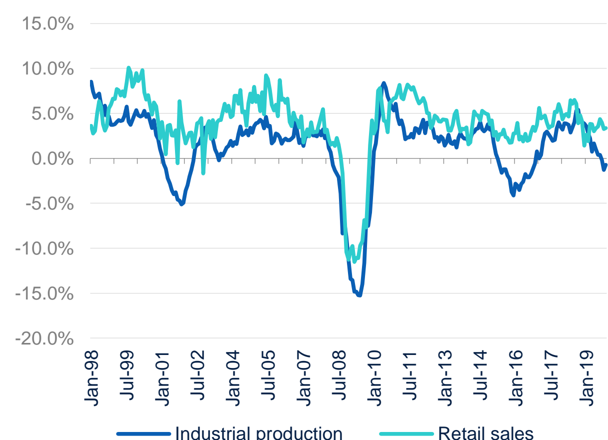
Therefore, signals of **stretched valuations in some assets** (equity, corporate bonds and commercial real estate) raise the vulnerability of private sector to a sell-off in financial markets. The **re-surge of liquidity tensions in funding markets such as the repo segment** (BIS, 2019) is an additional factor of uncertainty. The more limited margin of maneuver to adopt countercyclical policies (the Fed's strategic review should be understood in this context) may exacerbate the severity and duration of a potential recession.

The lower global demand caused by a US slowdown would translate into a fall in world trade and commodity prices. The preference for safe-haven assets would coexist with bulky capital outflows from EM and currency depreciations. The impact would be more severe in those economies with higher trade openness and dependence on exports of raw materials. Monetary stimuli by Developed Markets (DM) would partially offset the tightening of global funding conditions, providing EM central banks some room for gradual interest rate cuts in the mid-term.

US CORPORATE PROFITS (% GDP)

Source: BBVA Research, Bureau of Economic Analysis

US INDUSTRIAL PRODUCTION AND RETAIL SALES (YoY, %)



Source: BBVA Research, Haver

[1] Based on New York Fed model, the probability of recession twelve months ahead remains close to 23.6%.

[2] According to Sham indicator, if the unemployment rate (in the form of its three-month average) is close to 0.50 percentage points above its minimum from the previous 12 months, then the economy is entering into a recession. In November, this indicator remains close to 0.033.

[3] Savings rate of US households remains close to 8% of GDI (maximum from end-nineties) and its leverage ratio continues to fall (<100% of GDI).

A disorderly deleveraging process in China

The decision of Chinese authorities to conduct 'selective easing' measures to deal with the effects of trade The decision of Chinese authorities to conduct 'selective easing' measures to deal with the effects of trade tensions, instead of implementing a broader stimulus program, has contained the fears on a potential resurface of the debt cycle. Despite this, **the ratio of non-financial debt on GDP has continued to rise**, reaching a maximum of 261% in Q219. Social financing figures reinforce this upward trend for the second part of the year, supported by the expansion of banking loans and the lower pace of reduction in 'shadow banking' operations. The balance sheet position of corporates is key to explain this dynamic**: some firms are facing difficulties to repay its debts** due to recessive forces operating on the industrial sector (profit-squeeze, weaker external demand and increasing financial pressures). Hence, although a disorderly deleveraging process is an event with relatively low probability in the short-run, **the ongoing build-up of financial vulnerabilities**, in a context of heavy reliance on short-term stimulus (additional interest rate cuts and fiscal easing focused on infrastructure), **keeps this source of instability well alive in the medium term**. We highlight as warning spots to be monitored the following:

(i) **Financing pressure faced by some small and midsize banks** (mainly city and rural banks exposed to local governments and corporates), due to significant dependence on wholesale funding (bonds from investors and/or interbank loans by big banks), weaker profitability, lower capital ratios and tougher NPL disclosure norms. The role played by big banks as lenders of these entities could generate spillovers on the banking system if a liquidity dry-up takes place. Our early warning model of banking crisis keeps China high on the risk zone in the medium term;

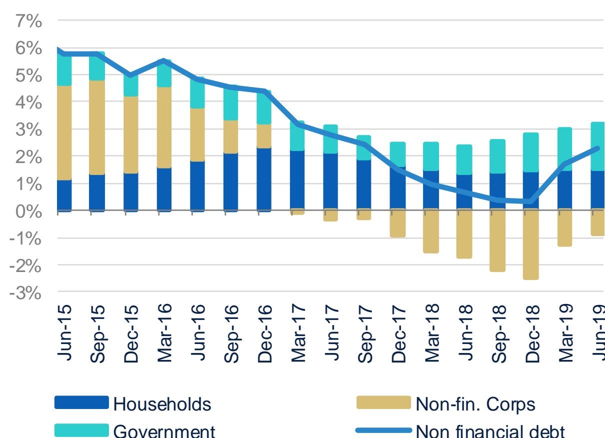
(ii) **Wave of defaults on corporate bonds** amidst downturn of revenues and liquidity tightening, especially in some provinces and sectors (manufacturing conglomerates). With government support waning for large state-owned groups, the outlook for China's private sector has deteriorated. The question mark on this issue is to what extent authorities will accept market-based restructuring in the case of systemic enterprises;

(iii) **Distortions to credit allocation**, in favor of small firms with a riskier credit profile, and

(iv) **Rising household debt**, already close to 55% of GDP (+7.5pp in two last years), *versus* the 40% EM average.

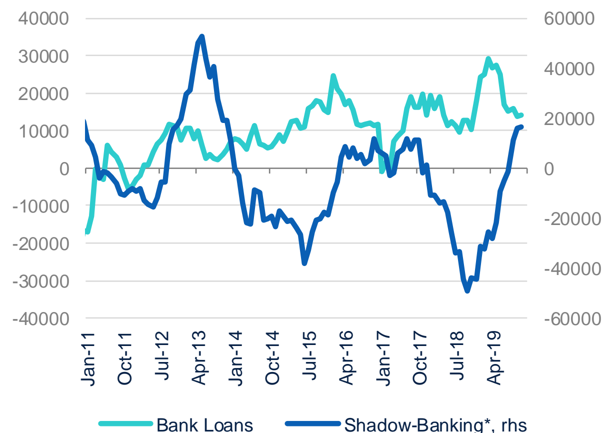
Under an adverse scenario in China, a global risk re-pricing would have a differential effect on EM risk premia. The macroeconomic impact would be more severe for economies more open to world trade, particularly those highly dependent on commodity exports and/or trade flows from China. DM would resort to accommodative monetary policies whereas EM would raise rates to contain capital outflows and FX depreciations.

CHINA: DEBT BY SECTOR (YoY CHANGE)



Source: BBVA Research, Haver

CHINA: SOCIAL FINANCING FLOWS (100 MIL. YUAN, CUM. 12MONTHS)



(*) Shadow banking: entrusted loans, trust loans, acceptances and corporate bonds. Source: BBVA Research, Haver

Climate change: transition costs in the road to mitigate physical risks

Climate change constitutes a growing burden for the economy. The global rise in temperatures observed during the 20th century cannot be only attributed to natural factors; the role played by the human activity is necessarily determinant to explain the sustained increase of CO_2 world emissions at its root. Apart from the physical costs of more frequent disruptive climate events, **the persistent increase of temperatures may impact negatively on GDP per capita through a lower productivity and job creation** (Kahn, M. et al., 2019).

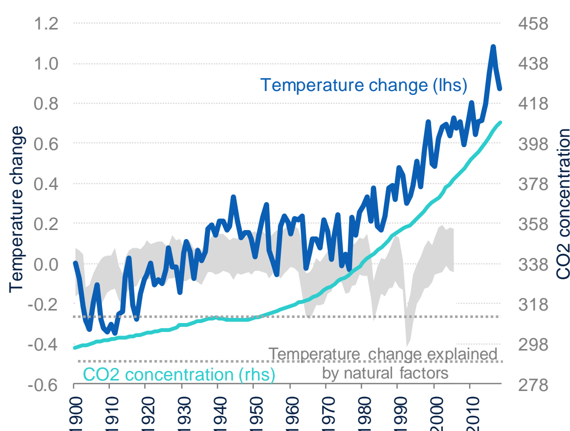
The effect of the depletion of natural resources has not so far been completely internalized as a cost of economic activities. Moreover, the maintenance of subsidies for fossil sources contributes to keep a mix of energy rich in carbon which is inconsistent with limiting warming to 1.5º-2ºC above the historical average. To avoid irreversible changes, a well-defined and comprehensive strategy, as well as an impeccable implementation, is a must. In order to reduce carbon emissions minimizing its impact on the GDP growth, it is necessary that private agents take ownership of the reduction targets to guarantee a smooth transition towards decarbonized activities.

The range of potential economic measures to deal with the climate change is still open to discussion and far from being implemented in a coordinated way. For instance, the European Green Deal, one of the most ambitious initiatives, requires political decisions out of the range of European authorities: carbon tax border or emissions standards are decided at European level but fiscal instruments such as fuel subsidies or public investments are defined by national governments. In the same vein, crowding in private funding through appropriate incentives is a necessary condition for the implementation of this type of programs.

In a relatively short term horizon, the lack of clarity and/or coordination about economic policies –that would open the door to a more dramatic action later on- **could provoke a sudden reassessment of asset valuations according to its climate risk exposure**, triggering a disorderly process of penalized “brown’s” and favoured “green’s”. The increase of the **‘climate risk premium’** and the consequent stress across several companies through the financial system would be the main contagion channels to the global economy (Grippa, P. et al., 2019). The negative impact of this event is likely to be mitigated by liquidity provisions from central banks[4] and/or regulations trying to manage expectations towards economic activities less carbon intensive. Public preferences on the matter could also put significant pressure towards a tipping point.

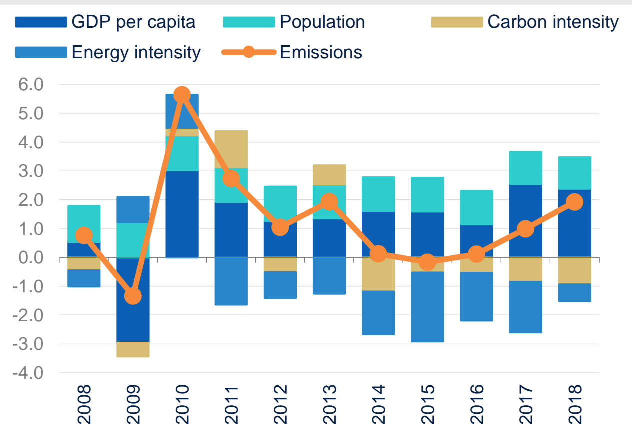
All in all, in the extent that climate change policies are more broadly deployed, the climate change will be less present as a risk and more as a feature of the baseline scenario, an outcome of the structural change towards a more environmentally sustainable economy.

GLOBAL TEMPERATURE CHANGE (DEVIATION RESPECT TO 1850-1990 AVERAGE) **AND CARBON CONCENTRATION IN ATMOSPHERE** (PARTS PER MILLION)



Source: Andrés, J. and Doménech, R. (2020) from NOAA and https://www.globalchange.gov/

CONTRIBUTIONS TO WORLD CARBON EMISSIONS GROWTH (ANNUAL RATE, %)



Source: BBVA Research, IMF

[4] Central Banks role is getting increasingly active in the alert on climate risks, their identification, disclosure and management, given its impact on financial system stability. That is why banking supervisors are including the climate risk in banking stress tests (BoE, EBA).

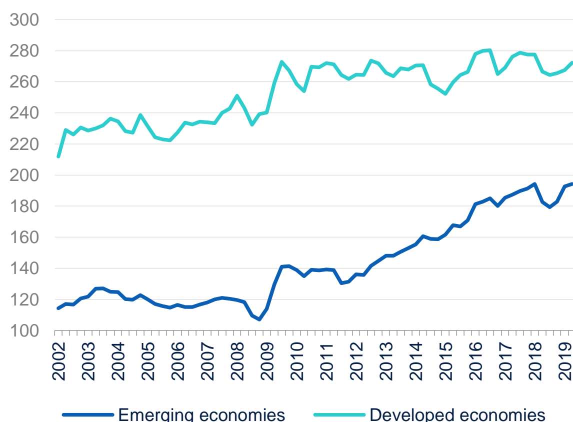
Annex I. Consequences of ‘irrational exuberance’. Under a self-inflicted financial panic?

The relative **disconnection between financial markets and real economy** has been a distinctive feature of the global outlook during last years. Central banks’ monetary easing has been masking the deterioration observed in the balance of fundamental risks, mainly from 2017 coinciding with the irruption of the trade and technological war (supply shock). Since then, the persistent increase in the degree of policy economic uncertainty at global level has coexisted with very low levels of financial volatility (beyond one-off bounces).

The return of ‘balance sheet’s expansion’ policy and the expectation of low for longer interest rates have fuelled ‘risk taking’ strategies in financial markets. Hence, while the nominal GDP of the US, Eurozone and Japan has increased by $5.3 trillion from 2008, their central banks’ balance sheet has expanded by $10 trillion in the same period. The remainder has materialized in a liquidity boost that supported asset prices and kept financial volatility anchored at depressed levels. A **new wave of debt buildup** is certainly one of the most remarkable consequences of this particular environment of ‘irrational exuberance’. In fact, the ratio of total global debt on GDP has already reached levels of 230% in 2018 according to World Bank, with Emerging Markets registering the largest, fastest and broad-based leverage process of last decades (signals of a riskier debt composition –weight of debt denominated in hard currency and role played by non-banking institutions as borrowers- is also remarkable).

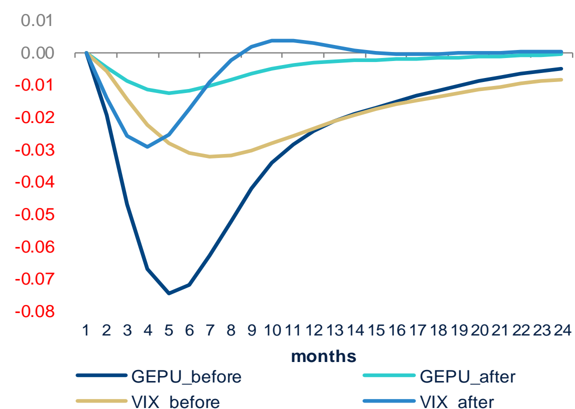
According to our calculations, the sensitivity of global GDP growth to a non-financial uncertainty shock has declined significantly after Lehman crisis, being almost negligible nowadays. However, **the response of global growth to a financial shock (VIX increase) continues to be relevant** and similar than in the past in a short-term horizon (in the medium term, it is less persistent than in the pre-crisis period) (*see graph on the right*). An increase of interest rates triggered by a spike in inflation and/or an uneven monetary tightening –main cause of financial shocks in the past– represents a low-probability risk event in the near future. But **a self-inflicted financial panic**, **in which debt vulnerabilities mentioned above act as amplifiers** of negative effects triggered by any scenario identified in our risk assessment, **is an event** with a not negligible likelihood of occurrence given the broad range of shocks that might cause it.

NON FINANCIAL DEBT (% GDP), 2Q19 LAST AVAILABLE DATA



Source: BBVA Research, BIS

EFFECT ON GLOBAL GDP OF A TYPICAL UNCERTAINTY SHOCK (FINANCIAL & NON FINANCIAL) (*) (PROPORTIONAL CHANGE IN GLOBAL GDP GROWTH, PP, %)



(*) Financial uncertainty measured through VIX and non-financial uncertainty through Global Economic Policy Uncertainty (GEPU) Index | ‘Before period’: 1992-2007; ‘after period’: 2012-Nov2019 | Methodology: Structural Vector Autoregressive Model
Source: BBVA Research, Haver, https://www.policyuncertainty.com/

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