Too Slow For Comfort

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Federal Reserve Bank of Chicago
28th Economic Outlook Symposium
Global growth continues to slump

- **US**: Same story, but improving
- **Europe**: Muddling through
- **EMs**: From growth drivers to risk generators

### IMF GDP Forecast vs. July IMF Report

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**Hyperactive Central Banks**

**Shocking oil developments**
Global growth disappoints

Expected GDP growth in 2014

Note: In countries with no CX activity, CF numbers were taken.
Source: CEMEX, Consensus Forecast
2015, somewhat better but not much

Expected GDP growth in 2015

Note: In countries with no CX activity, CF numbers were taken.
Source: CEMEX, Consensus Forecast
US: same story, but slowly improving

Growth trending up

- Households with room to spend
- Corporate sector in good shape
- Lower fiscal drag
- Loose financial conditions
- Pent up housing demand

Fed willing to risk inflation to assure growth

Activity Index.
Source: Cemex
Job creation continues to be the key driver

Huge Pent up Housing Demand should boost housing market in the coming years

Assuming 1.5 M in equilibrium

- Households formation: 1.20
- Second homes: 0.15
- Replacement: 0.35
- Manufactured homes: -0.20
Europe: disappointing expectations once again ...

Some recovery expected for 2015, but with lower rates of growth and higher uncertainty.

Growth expectations downgraded in the core

- Germany: shock to business confidence expected to be transitory.
- France: increasing fears on the mid-term outlook.
- Spain: not quite self-sustained growth yet

German IFO cooled off significantly

Source: IFO

GDP growth for 2014 according to CF
Source: CF
No recession, but no growth

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EUROPE

GERMANY

FRANCE

SPAIN

ITALY

UK
Reasons for some optimism

- Financing costs at lowest levels ever ...
- ... and spreads back to pre-crisis levels.
- Exchange rate depreciating
- Lower fiscal drag
- Oil prices below $70/barrel

Monetary policy action growingly likely

And don’t forget about falling oil prices
Inflation remains at “dangerous levels”

Inflation below ECB comfort zone

Disanchoring inflation expectations

Inflation (% yoy)
Source: Eurostat

Inflation swap related (% yoy)
Source: DS
Deflation, collateral damage in Europe

- Higher increase in spreads
- “Sudden stop” risk
- Credit crunch
- Economic contraction and necessity of restoring public finance

Deflation
- More difficult to repay debt
- Fiscal adjustment more severe
- Contraction of activity (shy consumption and investment)

Risk of default
- Increase in spreads
- More necessity of real adjustment (fall in demand)
- Social unrest reignites (austerity fatigue in periphery - rescue fatigue in the core)

Break-up risk

Economic contraction and necessity of restoring public finance
Maybe not in the death bed anymore, but not yet cured
The risk of break-up seems to have vanished. More Europe is needed.
The risk of break-up seems to have vanished. More Europe is needed. Have the European authorities really understood that we cannot stay in the grey zone?

Disintegration

Resort to traditional tools (devaluation, strong monetary support) to alleviate the real effect (unemployment) of the needed adjustment. High costs (default, banking linkages, fear of floating)

Enhanced integration

- Short-term easing
- Mid-term reforms
- Long-term integration and redistribution

Implies loss of sovereignty

Current crisis, the necessary trigger to push forward the European Project
European crisis is primarily institutional, Eurozone is an unfinished project

- **Institutional reform/Fiscal reform**
  - Lender of last resort (ECB)
  - Fiscal integration (European Treasury) and Eurobonds

- **Incentive mechanisms (fiscal, regulatory, etc.)**

- **Banking Union**
  - Pan-European banking resolution
  - European Deposit Insurance Institution
  - Regulation and supervision

- **Structural reforms across Europe, predominantly in the periphery (competitiveness) but not only**

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**Dominance of domestic politics**
Diminishing returns to the “buying time” strategy
Increasing social risk
EMs: from growth drivers to risk generators

China’s Shadow Banking too big to control

- Limited risk from Shadow Banking: no Western style connection with formal banking and China can afford the rescue
- Soft landing, but how “soft” the landing?

- Brazil perspectives worsened significantly: stagflation, policy uncertainty, deteriorating fiscal and current account position, persistent supply constraints.

- Russia stagnating: conflict with Ukraine taking its toll, oil dependency.

Total social financing flows and breakdown, as % of GDP
Source: People’s Bank of China
Cuestionado el crecimiento de Emergentes
A tough environment for emerging markets

Global liquidity reversal

Decreasing contribution of China

Structural problems

Political risk/geopolitics
Impact of China slowdown/commodity prices drop on commodity producers (LatAm)

China affects LatAm countries not only by the direct trade channel but also by their impact on commodity prices.

Source: IMF, UNTACD
General depreciation of EM currencies, thought more so in oil exporting economies

Oil prices plunge weigh on commodity currencies

Depreciation vs the USD from one month ago.
LatAm countries: our medium term assessment reaffirmed

Venezuela: Worse MR Outlook
Argentina: "Alternative routes"
Brazil: The giant with feet of clay
Colombia: Growing up with criteria
Peru: The US anchor
Mexico: Well known quality
Chile: Better MR Outlook
Dynamics of oil and Central Banks behind the evolution of activity and markets

Falling oil prices

Even less pressure on Central Banks to begin policy normalization

Brent oil price
(USD per barrel)

Central Banks balance sheet (Dec.07=100)
Source: Central banks and CX

Source: Datastream
Oil prices impact different countries in different ways

Positive supply shock for importing countries, including the US.

Impact on EMs, depending on their commodity dependence, particularly oil.

Source: CX-Economics
US becoming self-sufficient in energy, but oil price drop reduces returns to investments

- Energy independency => reindustrialization
- Significant geopolitical implications

Weekly U.S. Field Production of Crude Oil
(Thousand Barrels per Day)

Natural gas prices
(USD Mill. Per Btu’s)

Falling oil prices diminishes growing US advantage

Source: EIA and BP
Currencies of oil exporting countries strongly affected

Oil prices plunge weigh on commodity currencies

- Depreciation vs the USD from one month ago.

Bar chart showing percentage changes in currency depreciation for various countries. The chart indicates a significant depreciation for oil exporting countries, with Russia showing the largest drop at -21%. Other countries listed include Poland (POL), Turkey (TUR), Indonesia (IDN), India (IND), China (CHN), Mexico (MEX), Brazil (BRA), Thailand (THA), and Poland (POL). The chart also notes that oil importing countries are less affected.
Central Banks: pulling in different directions

Central Banks have expanded their balance sheets aggressively in last few years

- Even adding the QE announced by the ECB, the monetary impulse in Europe would be much lower than that in the US or UK.

- Balance sheet reduction is not yet on the table.

- More stimulus needed in Europe? How aggressive?

- Hidden agenda of exchange rate depreciation (currency war?).

- Central Banks prioritizing growth over inflation or financial stability

What is the “new” role of Central Banks? Assuming too many responsibilities?
Central Banks: pulling in different directions

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What is the “new” role of Central Banks?
Assuming too many responsibilities?
Not all transmission mechanisms of QE work in every country.

- Confidence
- Policy signalling (low interest rates)
- Portfolio rebalancing
- Market liquidity
- Money
- Asset prices and the exchange rate
- Total wealth
- Spending and income
- Inflation
- Bank lending

- Cost of borrowing
How the transmission channels worked in Japan and Europe?

QE announcements have had a rapid impact on exchange rates

Japan. Stock market index and exchange rate
Source: DS

Impact on the economy not as clear

Nikkei (right)

Eurostoxx 50

QE announcement

Yen/$

$/€

QE Announcements

Impact on the economy not as clear
How the transmission channels worked in Japan and Europe?

Impact of QE announcements on FX

Months from the QE announcement

Euro and yen vs USD. 100 = date of the first mention to QE

Source: DS and CX Economics
Diminishing returns of QE, risks of remaining at the ZLB and increasing potential of collateral damage

Corporate yields at all time lows

- Exchange rate volatility (disadvantage of being the first mover)
- Increased market risk: fixed income bubble? Corporate bond bubble? Over-valued stock market relative to fundamentals?
- Economic impact of rising rates or reducing balance sheet. Risk or remaining trapped at the ZLB
- Financial stability risk with very low rates (search for yield, magnified movements, unclear price signals)

Impact on EMs (exit of funds, exchange rate volatility, pressure on domestic rates, ...)

Corporate issuances in EMs skyrocketed

- AAA Corp.
- BBB Corp.
- High Yield Corp.
- ABS
- MBS
- Agencies
- AAA Corp.
- BBB Corp.
- High Yield Corp.

US
Europe

Range: MAX-MIN last 10 years
Last observed

Corporate issuances in EMs skyrocketed

$ billion

China
EM-30 (exc. China)
China's share

'05 '06 '07 '08 '09 '10 '11 '12 '13 '14a
Too many worries in the short term and Central Banks hide other pending issues

- Necessary deleveraging
- Pending fiscal consolidation
- Politics/Political economy
- Integration process in Europe / Banking Union
- Geopolitics

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