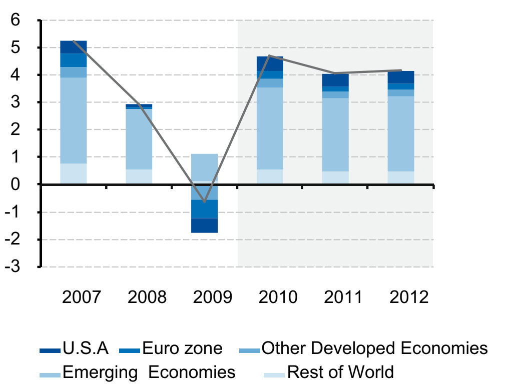
Global environment: the North slow, the South fast

The global economy continues to grow with force, basically in the emerging countries, while cyclical and financial concerns are predominant among the advanced economies.

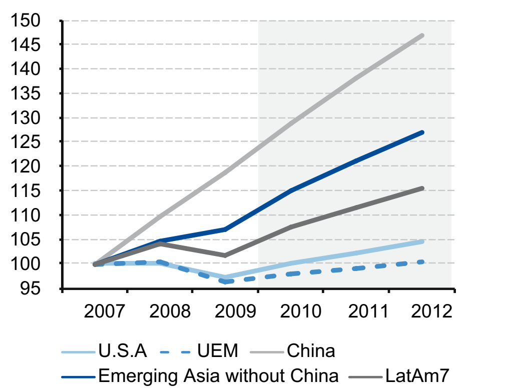
World growth continues to be strong and it is expected to reach 4.7% in 2010 and 4.1% in 2011 (Graph 5), remaining practically unchanged with our outlook of three months ago. This good performance is fundamentally due to the solidity of the emerging economies which have been less affected by the financial crisis and have, therefore, recovered more quickly. In contrast, renewed concerns about the cycle in the U.S. have come together with the financial concerns that continue to predominate in Europe, where macroeconomic and financial adjustments are still pending. In this sense, the outlook for the next two years continues to reveal important gaps between growth in the advanced economies and that of the emerging ones (Graph 6), even though the latter are starting a controlled slowdown that will diminish the risk of overheating their economies.

Graph 5
Global GDP growth and contributions



Source: BBVA Research

Graph 6
GDP level: 2007=100



Source: BBVA Research and Datastream

Also, there are important differences as to policies in each of these groups. In the United States, it is expected that the monetary expansion will intensify in relative terms compared to Europe (and to most of the other countries), which has already generated a depreciaiton of the dollar versus the euro and complicated the recovery in Europe a little more. In the emerging economies, there continues to be a strong asymmetry among the foreign currency policies between Asia and Latin America, which is forcing the Latin American countries to support (along with the euro) a disproportionate part of the appreciation of the exchange rate, derived from the renewed easing of monetary policy in the United States.

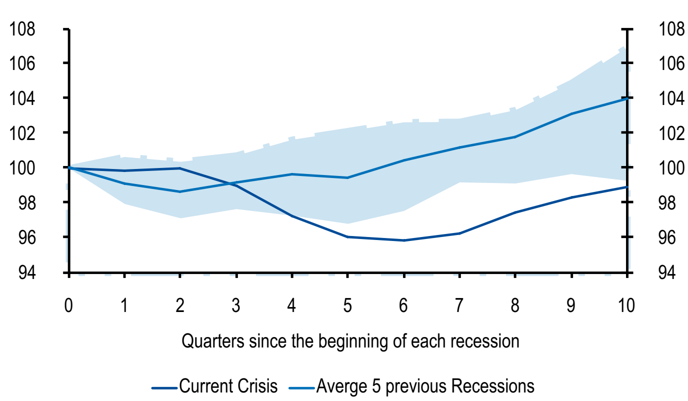
Growth in the United States will maintain its weakness due to the continued unleveraging process of households, even though it is quite improbable that a relapse in the recession will be produced. In the last quarter, the existence of relatively weak indicators of economic activity in the United States has set forth the possibility of a relapse into a new recession phase. The weakness observed in some key sectors, which had directly benefited from the fiscal support provided through incentives for spending (household and durable goods) is an important sign that private demand in the United States cannot recover at a rapid pace. And this is only the result of the unleveraging process that households are currently undergoing, as well as of the weakness of the labor market. This will continue to favor the existence of higher savings levels than those observed since the second half of the decade of the 80's. Even though this trend is the correct direction to counterbalance the United States growth model, it also increases cyclical concerns, given that consumption (one of the pillars of recovery in prior recessions and the main GDP component from the demand side) will remain at relatively low levels, only partially offset by increased investment in equipment by companies.

The recent concerns regarding the situation of the U.S. housing sector are excessive, and the possibility that there will be a relapse in real estate prices is quite remote. It is evident that there still exist elements of concern such as a rise in the available housing supply, which could additionally increase due to new home foreclosures (whether they are a consequence of the rise in delayed payments or because owners failed to make the payments due to a higher mortgage value vs. the actual home value--negative equity--). But there are also favorable support elements such as the great improvement of the accessibility indicators since the crisis began, and, with a medium-term outlook, some demographic trends that should contribute to boost demand. Therefore, the most probable scenario is that we will face a relatively stable period of housing prices, while the prior excesses are being absorbed. In any case, the banking system should be able to assume a moderate drop in these.

Definitely, the existing burdens on consumption and the low probability that new fiscal stimuli will be produced --taking into account the current dimensions of the deficit, and especially if there is a change in the balance of power, following the November elections for Congress-- imply a much slower exit of the crisis for the United States than that experienced in previous cycles (Graph 7), in line with our previous projections. The possibility that a relapse will be

Graph 7

GDP in the U.S.: current cycle vs. prior recessions*. Start of each recession=100.



* Shaded area: GDP range during the last 5 recessions. Source: BBVA Research and NBER

produced in a new recession phase in the United States is very low. In any case, the lack of solidity in internal demand will lead the United States to exert increasingly greater pressure on the rest of the world (especially on countries with a surplus in their current account) to increase its demand and contribute to the necessary global re-equilibrium. The renewed monetary expansion of the United States can be interpreted within this context as a formula to transfer part of this adjustment to the rest of the world.

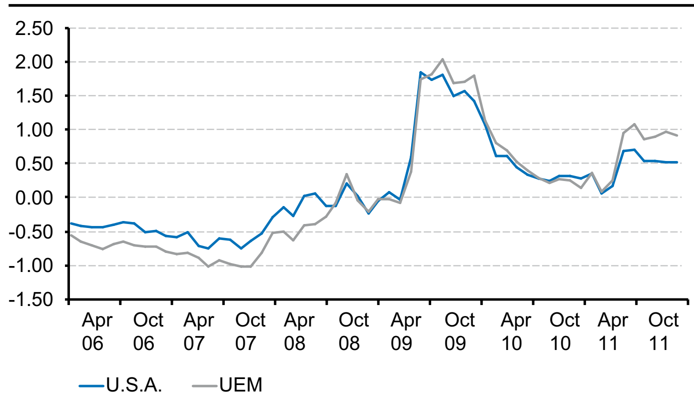
Financial tensions in Europe continue to be the main source of concern, although systemic risk is lower than before the summer. Fiscal consolidation continues to be a key element for sustained trust and will not have a significant impact on growth beyond the short term.

Following the decisive progress experienced with regard to fiscal consolidation, the steps taken to support governments having greater difficulties and, particularly, after testing the resistance of the financial sector, there has been a qualitative change in the dynamics experienced by the crisis in Europe. On one hand, even despite the fact that the spreads of sovereign debt have remained relatively stable, the markets have begun to differentiate between the various sovereign assets, thereby reducing the risk that a systemic event might be produced. . Also, the financial markets have begun to open in a selective manner, and new debt issues are an evident sign of the easing of tensions.

Despite all this, the tension of the financial markets in Europe continues to be the main source of risk for the region (Graph 8), especially due to the existing relationship between concerns regarding sovereign debt and the risks of the financial sector. Also, the recent strengthening of the euro is an added cyclical challenge, given that the economies that have experienced a better performance are those that have been backed by external demand. This implies that it is even more important to decisively approach, in the short term, the sources of the regional macroeconomic vulnerability: fiscal sustainability and external imbalances, in addition to avoiding greater delays in the restructuring of the weaker parts of the banking systems. The key is to continue to take steps that will contribute to re-establishing trust and thereby reduce tensions in the markets, contributing to restore the solidity and autonomy of demand of the private sector. Moreover, so as to be able to sustain long-term growth, it will be fundamental to realize structural and institutional reforms, and, among the latter, those especially focused on avoiding and resolving potential fiscal imbalances in the countries.

Graph 8

Financial tensions index



Source: BBVA Research

The monetary policy of the advanced economies will be lax for a long time, adding pressure on the exchange rates throughout the whole world

The very low outlook for growth and of weak inflationary pressure on the advanced economies will translate into low interest rates for a prolonged period of time in the three main advanced economies (the United States, Europe and Japan). However, within a context marked by renewed cyclical concerns and by the scant space for additional fiscal stimuli, the attention of the markets is centered on the new round of unconventional steps of monetary expansion (usually known for its denomination as "Quantitative Easing" 2, or QE2). The expectations of this new increase in liquidity have reduced the dollar exchange rate in a generalized manner, even in relation to the euro. Going forward, given that the greater part of the steps taken toward monetary expansion have already been discounted by the markets, exchange rates should begin to move in a greater measure in accordance with the long-term fundamentals, which means a strengthening of the dollar compared to the euro, due to its better outlook for growth and a greater entry of investment flows. At the same time, rallying pressure will continue to be maintained on the exchange rates of the emerging economies, due to the increase in global liquidity, the greater solidity of its economic fundamentals and the positive profitability spreads that favor new entries of capital flows.

The emerging markets are facing increasingly greater dilemmas with regard to the policies derived from the solid growth experienced, from abundant global liquidity and from the competitive interventions in the exchange rates.

The emerging economies continue to grow strongly, and Asia remains at the head of world recovery. Both in Asia and in Latin America, private internal demand is substituting stimuli induced by the policies adopted as a main source of the recovery. Going forward, growth will slow down in Asia to the extent that countries try to control internal credit growth, thereby reducing the risk of reheating the economy. But the region will continue to be the main contributor to world growth.

Both Asia and Latin America are facing increasingly greater dilemmas with regard to monetary and exchange policies, as they debate between cooling strong internal demand, thereby avoiding strong capital entries and maintaining their competitiveness regarding foreign markets. Some countries have begun to introduce administrative measures to discourage a strong entry of capital flows, while other countries have delayed the path foreseen by hardening their monetary policy.

Taking into account the flexibility of the exchange rates in Asia (and China in particular), Latin America is facing having to assume a disproportionate part of the adjustment, to the point that future appreciations in the exchange rates could begin to constitute a problem for growth. Therefore, many countries of the region are considering new interventions in the currency exchange markets, although experience has shown that its effectiveness is limited, fundamentally contributing to slow down the appreciation of the currencies, although not avoiding it. Still, there is the risk that the rise of intervention in the currency markets will end by provoking commercial reprisals. This shows the importance of applying greater flexibility regarding the exchange rates in Asia, with the aim of providing a greater margin for acting in terms of policies for the rest of the world.

Indicators and Forecasts

Chart 1

United States Indicators and Forecasts

	2008	2009	2010	2011	1Q10	2Q10	3Q10	4Q10	1Q11	2Q11	3Q11	4Q11
Economic Activity												
GDP (US$ billions)	14.369	14.119	**14.585**	**15.019**	14.446	14.579	**14.641**	**14.675**	**14.793**	**15.003**	**15.108**	**15.171**
Nominal growth (%)	2,2	-1,7	**3,3**	**3,0**	2,8	3,9	**3,7**	**2,8**	**2,4**	**2,9**	**3,2**	**3,4**
Real growth (%)	0,0	-2,6	**2,7**	**2,3**	2,4	3,0	**3,0**	**2,3**	**1,9**	**2,1**	**2,4**	**2,5**
GDP deflactor	2,1	1,2	**0,6**	**0,9**	0,5	0,8	**0,9**	**0,7**	**0,6**	**0,9**	**0,9**	**1,0**
Personal consumption (real % change)	-0,3	-1,2	**1,5**	**1,8**	0,8	1,7	**1,7**	**1,9**	**1,8**	**1,7**	**1,8**	**1,7**
Government consump-tion (real % change)	2,8	1,6	**1,0**	**1,9**	1,1	0,6	**0,7**	**1,5**	**2,3**	**1,8**	**1,8**	**1,8**
Gross fixed investment (real % change)	-6,4	-18,3	**5,3**	**6,3**	-2,0	5,1	**8,0**	**10,3**	**10,4**	**6,7**	**4,6**	**3,7**
Construction[1]	-24,0	-22,9	**0,9**	**3,8**	-6,2	4,9	**2,2**	**3,3**	**7,5**	**2,2**	**2,9**	**2,8**
Industrial production (real annual % change)	-3,3	-9,2	**5,7**	**4,6**	2,7	7,2	**6,5**	**6,2**	**5,5**	**4,7**	**4,3**	**3,8**
External Sector (constant US$ billions)												
External balance	-710	-386	**-568**	**-632**	-479,8	-539,2	**-576,9**	**-675,6**	**-700,6**	**-594,8**	**-581,5**	**-651,6**
Total exports	1.843	1.578	**1.861**	**2.108**	1.757,8	1.817,9	**1.908,8**	**1.957,9**	**2.012,2**	**2.066,2**	**2.155,5**	**2.197,8**
Total imports	2.554	1.965	**2.428**	**2.547**	2.237,6	2.357,1	**2.485,7**	**2.633,5**	**2.712,8**	**2.661,0**	**2.737,0**	**2.849,4**
Current account balance (% of GDP)	-4,6	-2,7	**-3,8**	**-4,4**	-3,1	-3,4	**-4,0**	**-4,8**	**-5,0**	**-4,1**	**-3,9**	**-4,5**
Prices (annual % change)												
Final annual inflation	0,1	2,7	**0,9**	**1,1**	2,3	1,1	**1,1**	**0,9**	**1,0**	**1,6**	**1,2**	**1,1**
Average annual inflation	3,8	-0,4	**1,6**	**1,2**	2,4	1,8	**1,2**	**1,0**	**1,0**	**1,4**	**1,3**	**1,2**
Other Indicators												
Primary fiscal balance[2] (% of GDP)	-3,2	-10,0	**-10,8**	**-8,9**	-	-	**-**	**-10,8**				**-8,9**

1 Residential investment
2 Fiscal Balance (% of GDP)
Note: forecasts in bold
Source: BBVA Research with Federal Reserve, Bureau of Labor Statistics

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