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Global Economic Outlook

Divergent growth, divergent policies

Fourth quarter 2010

2 November 2010

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Main messages

Global Economic Outlook

Divergent growth, divergent policies

- **Divergent growth:**
  - Emerging countries keep growing strongly, whereas cyclical and financial concerns dominate advanced economies. The global economy is expected to grow by 4.7% in 2010 and 4.1% in 2011.
  - Growth in the US will remain low - given ongoing household deleveraging and a weak labor market-. But a double dip scenario is very unlikely.
  - Financial stress in Europe is still a source of concern, but systemic risk is lower than before the summer. Fiscal consolidation remains crucial to sustain confidence and it will not have a large negative impact on growth beyond the short-term.
- **Divergent policies:**
  - Monetary expansion is set to intensify in the US in relative terms thus depreciating the dollar against the Euro and complicating Europe’s recovery.
  - Exchange rate appreciation pressures in emerging countries will continue due to increased global liquidity, strong macroeconomic fundamentals and capital inflows. This will increase monetary and exchange-rate policy dilemmas.
  - Asymmetry in exchange rate policy between Asia and Latin America continues, with the latter bearing (together with the euro) a significant part of the exchange rate appreciation derived from renewed monetary easing in the US.
  - Further appreciation in some Latin American countries would start to become a problem for growth.

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Outline

Global Economic Outlook

Divergent growth, divergent policies

Section I
A pause (not a double dip) in US activity

Section II
Still concerned about financial tensions in Europe

Section III
Global spillovers from very lax monetary policy

Section IV
Outlook: diverging growth and policies

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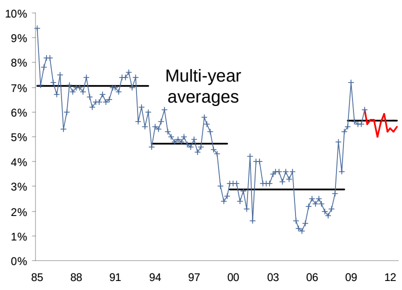
Section I
A pause (not a double dip) in US activity

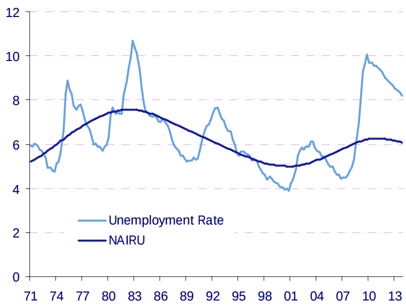
US will slow down as expected, given ongoing deleveraging and weak labor market

- Strong growth in the US has lost momentum as expected, given the withdrawal of fiscal policy measures, ongoing household deleveraging and high unemployment.
- The need to reduce household debt, persistence of weak labor income and the reduction in household wealth will imply higher saving rates than in the previous cycle, thus dragging consumption going forward.
- This will only be partially compensated by stronger investment in equipment and exports

US: Saving rate
Source: BBVA Research



US: Unemployment Rate
Source: BBVA Research and Bureau of Labor Statistics



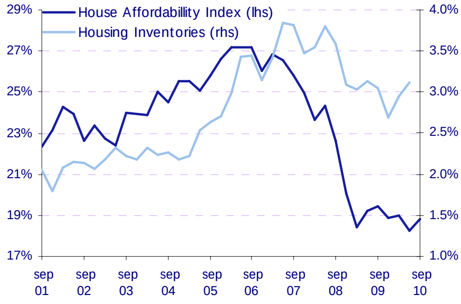
Section I
A pause (not a double dip) in US activity

A weak real estate market, but further price drops are unlikely

- Housing investment has remained relatively muted and will remain abated for some time while past excesses are reabsorbed. House prices have bottomed.
- The inventory of unsold houses remains high and there is a significant pent-up supply of future houses for sale coming from seriously delinquent mortgages. This is a downward risk for prices.
- However, the chance of a further fall in house prices is small as there are also factors supporting demand: improved affordability and strong demographic trends.

US: Housing inventories* and house affordability index**

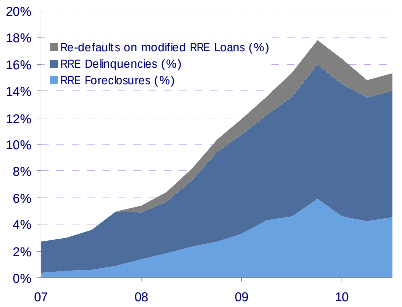
Source: Census Bureau, NAR and BBVA Research



* Percent of housing stock
** Mortgage payments to household income

US Residential real estate: foreclosures and delinquencies

Source: BBVA Research and IMF



Section I
A pause (not a double dip) in US activity

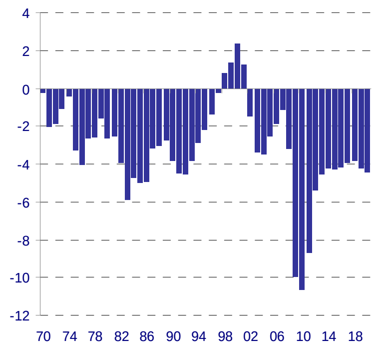
No room for further fiscal stimulus.

Monetary easing (QE2) will benefit investment and net exports

- Not much left to spend from approved fiscal stimulus. Unlikely to be extended, as room for further fiscal policy is scant.
- Fed still has room to maneuver. But wide uncertainty over effectiveness of QE2 to support economic activity. Most of the effects will go through investment (increase in price of risky assets) and exports (weak dollar). Low effect on consumption (low wealth effects)
- Overall, US will exit recession at a lower pace than in previous cycles

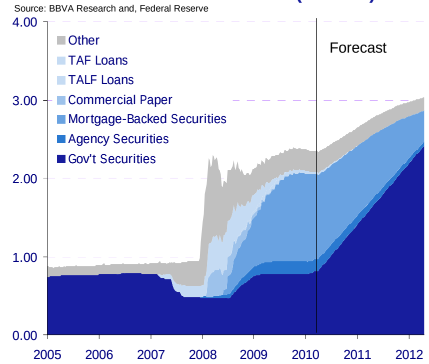
US fiscal deficit: CBO baseline (% of GDP)

Source: BBVA Research and US Treasury Dept.



Federal Reserve Balance Sheet (USD bn)

Source: BBVA Research and, Federal Reserve



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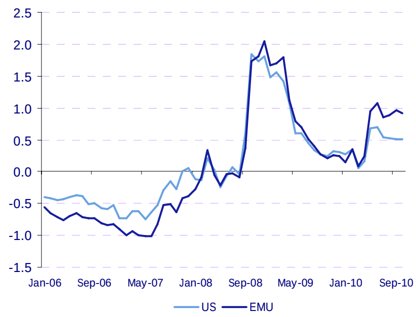
Section II
Still concerned about financial tensions in Europe

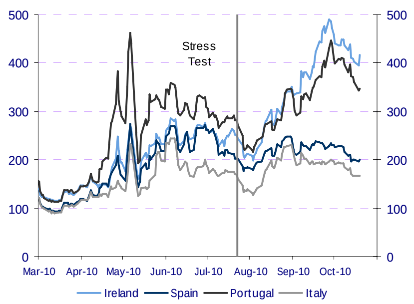
Financial tensions still high in Europe, but increased differentiation means lower systemic risk

- Financial tensions are still high (spreads on financial institutions and sovereign debt).
- Markets have started to highlight the differentiation within those asset classes, after measures to provide support to distressed governments and especially after the release of banks' stress tests. This contrasts the dynamics before the stress tests, dominated by risk aversion
- Increased differentiation reduces systemic risk. Also reflected in reopening of markets – though selectively– and renewed debt issuance.

Financial Stress Index
Source: BBVA Research



Sovereign CDS spreads in European peripheral countries
Source: Bloomberg & BBVA Research



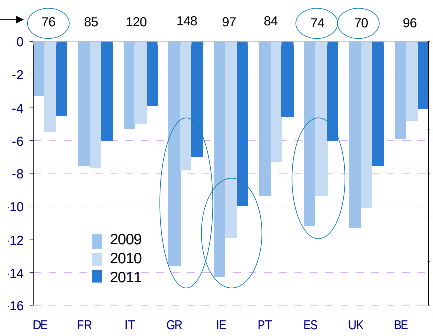
Section II
Still concerned about financial tensions in Europe

Uneven pace of macro adjustment in Europe

- Much of the recent differentiation reflects relative macroeconomic and financial sector underlying fundamentals.
- Fiscal consolidation and, especially external adjustment are advancing at different speeds, but not necessarily faster where it is more needed.

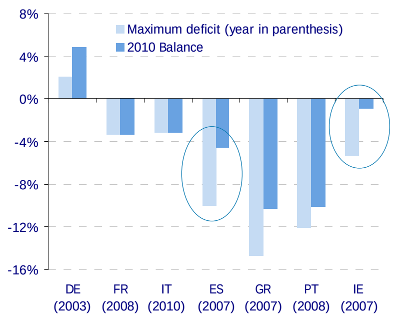
Projected deficit plans (% GDP)

Source: BBVA Research and National sources



Current account balance

Source: BBVA Research and AMECO



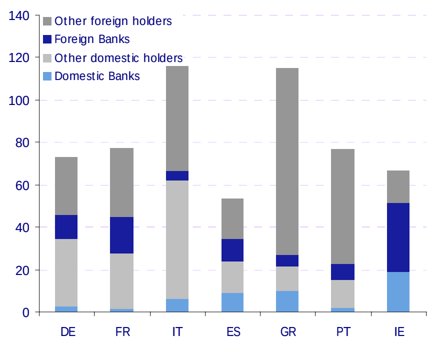
Section II
Still concerned about financial tensions in Europe

Financial and sovereign risk still high in Europe

- Even with increased differentiation, overall financial stress in Europe is still the main source of risk for the region especially given the link between sovereign concerns and exposure by the banking sector.

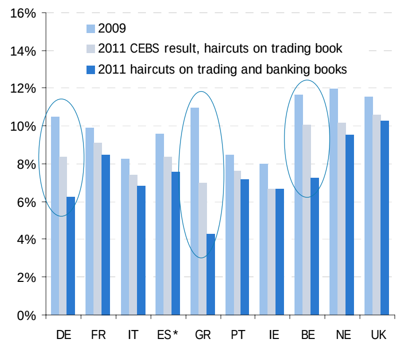
Sovereign debt holders in selected European countries (% of GDP)

Source: Joint BIS-WB-IMF database and BBVA Research



Average Tier 1 ratios after stressing sovereign exposure

Source: BBVA Research using CEBS data



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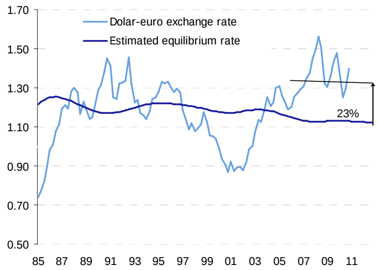
Section III
Global spillovers from very lax monetary policy

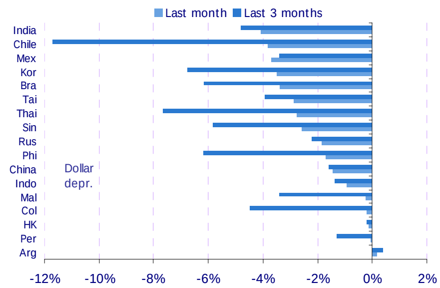
Very lax monetary policy in US has and will lift global exchange rates

- Prospects of very low growth and subdued inflationary pressures in advanced economies will translate into low interest rates for a prolonged period.
- Given most of QE2 has been priced-in by markets, euro-dollar exchange rates should have reached a maximum. Prolonged currency misalignments have not been sustainable for a long time. Going forward, exchange rate movements will depend on the perception of relative monetary policy in both areas.
- Appreciating pressures in EMEs will continue on account of growth differentials, increased global liquidity and renewed capital inflows.

Dollar-euro exchange rate and estimated equilibrium level
Source: BBVA Research



US dollar exchange rate changes against emerging currencies (% change)
Source: Datastream and BBVA Research



Section III

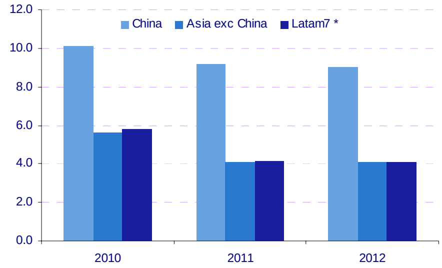
Global spillovers from very lax monetary policy

Emerging economies' strong growth and high global liquidity pose increasing policy dilemmas to emerging countries

- Emerging economies continue to grow strongly, with emerging Asia leading the world recovery. In both Asia and Latin America, private domestic demand is taking over policy-induced stimulus as the source of the recovery.
- Increasing policy dilemmas for emerging economies between cooling strong domestic demand and preventing strong capital inflows on the one hand and preserving competitiveness in foreign markets on the other.
- Some countries have started introducing administrative measures to discourage strong capital inflows and some others have slowed their rate of monetary tightening

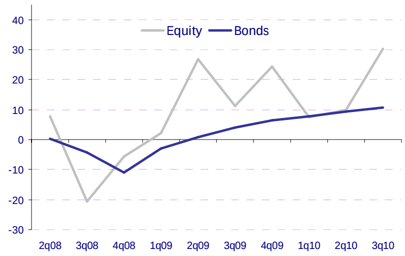
Emerging economies GDP growth (%)

Source: BBVA Research



Capital flows to emerging economies (USD bn)

Source: BBVA Research and EPFR



Section III

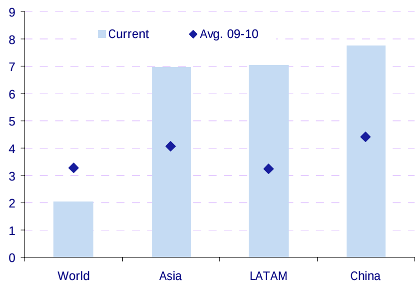
Global spillovers from very lax monetary policy

China holds the key to increased intervention in other currencies

- Given the inflexibility of exchange rates in China (and, to a lesser extent in the rest of emerging Asia), Latin America is facing a significant part of the adjustment.
- Further exchange rate appreciation could start becoming a problem for growth in some Latin American countries.
- This may prompt more exchange rate interventions and the introduction of outright capital controls. However, experience shows that their effectiveness if rather limited.

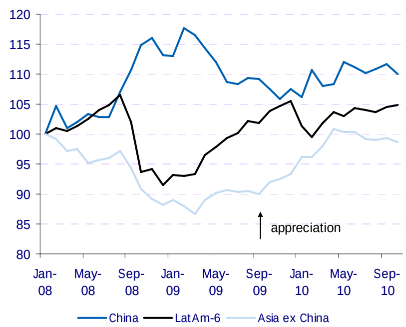
Emerging markets reserve accumulation (m-o-m % change, 3 month average)

Source: Bloomberg and BBVA Research



Real effective exchange rates

Source: BIS & BBVA Research



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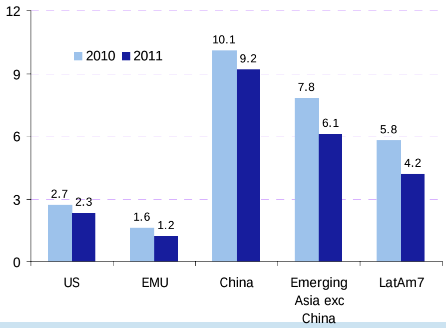
A tale of two slowdowns

- The global economy is expected to grow by 4.7% in 2010 and 4.1% in 2011.
- Emerging countries will keep their fast exit from the crisis, growing strongly and being the biggest contributors to global growth. Controlled slowdown will reduce risk of overheating.
- Slowdown in advanced economies will continue reflecting the weakness of private sector demand.
- Given relative growth prospects, and absent major changes in the perception of relative monetary policy going forward, the euro should have already reached a maximum. In the medium-term it will start to gradually weaken relative to the dollar.

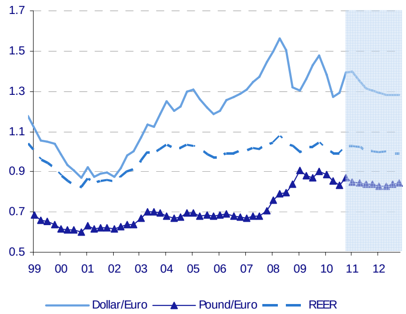
GDP growth forecasts

Source: BBVA Research



Euro exchange rates

Source: BBVA Research



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