BBVA Research

Global

Economic Outlook

Fourth Quarter 2010

Economic Analysis

- Emerging countries keep growing strongly, whereas cyclical and financial concerns dominate advanced economies.
- Growth in the US will remain low, but a double dip scenario is very unlikely.
- Financial stress in Europe is still a source of concern, though systemic risk is lower than before the summer.
- Prolonged lax monetary policy in the US will add pressure to global exchange rates and increase emerging market's policy dilemmas.

Index

Closing date: October 29, 2010

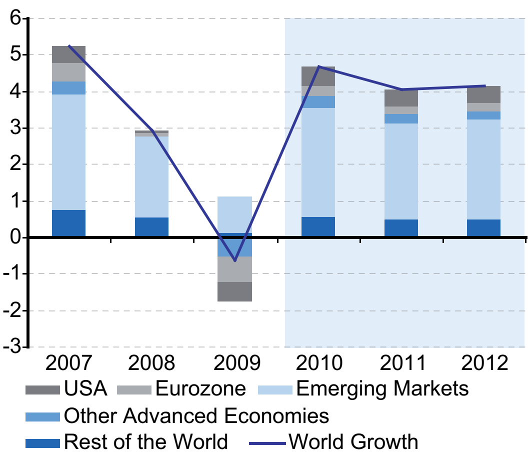
1. Summary: slow north, fast south

The global economy keeps growing strongly, mostly in emerging countries, whereas cyclical and financial concerns dominate advanced economies

Global growth continues to be strong, and is expected to reach 4,7% in 2010, and 4,1% in 2011 (Chart 1), mostly unchanged with respect to our forecast three months ago. This encouraging performance is mostly due to strong outturns in emerging economies, which have been less affected by the financial crisis, as their banking sector was in very good shape, and have thus recovered rapidly. In contrast, renewed cyclical concerns in the US have joined financial concerns still dominating Europe, where macroeconomic and financial adjustments are still underway. Thus, in line with our expected scenario, the outlook for the next two years continues to highlight the growth gaps between the advanced north and the emerging south (Chart 2) even if the latter also embarks on a controlled slowdown to ameliorate the risk of overheating.

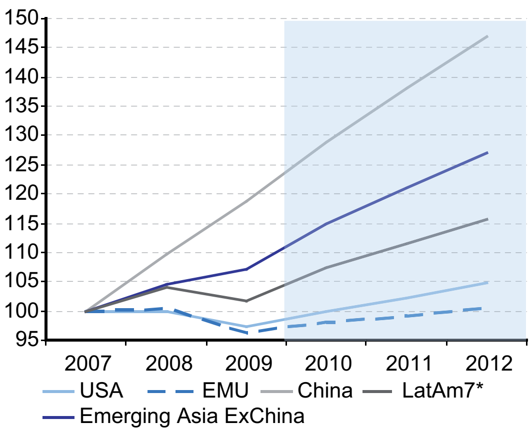
But there are also significant policy differences inside each of these groups. In the US, monetary expansion is set to intensify in relative terms with respect to Europe (and most other countries), and has thus been reflected in a depreciation of the dollar against the euro and complicating Europe's recovery. In emerging economies, a strong asymmetry in exchange rate policy between Asia and Latin America continues, forcing the latter to bear (together with the euro) a significant part of the exchange rate appreciation derived from renewed monetary easing in the US.

Chart 1
Global GDP growth and contributions



Source: BBVA Research

Chart 2
GDP level: 2007=100



* Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela
Source: BBVA Research and Datastream

Growth in the US will remain low given ongoing household deleveraging, but a double dip scenario is very unlikely

Over the last quarter, relatively weak indicators of economic activity in the US have raised the specter among market participants of a possible relapse into a recession –a double dip in economic activity–. The weakness observed in some key sectors that had benefited directly from fiscal support through incentives for purchases (durable goods and housing) is a strong signal that the recovery in private sector demand is still not self sustaining. This weakness is a consequence of an ongoing household deleveraging process and a weak labor market, which will continue to push households to save more than what was observed since the second half of the 1990s. Even though this is to be welcomed in the process of rebalancing growth in the US, it increases cyclical concerns since consumption (one of the pillars of recovery in past recessions) will remain muted and only partially compensated by stronger investment in equipment by firms and exports.

Recent concerns about the health of the housing sector are, in our view, excessive and the possibility of a relapse into further significant real estate price drops is very small, given that prices have declined by about 30%. There are certainly elements of concern, such as elevated house inventory levels and the potential impact of an unexpected further supply of housing from new foreclosures, which may come either from increased delinquencies or due to owners walking away from increasingly negative housing equity. But there are also elements of support, such as the huge gains in housing affordability since the crisis started and the demographic trends that should help prop up demand going forward. It is true that if house prices continue to decline, it might have a non-negligible impact on consumption, but at least the banking system seems in a relatively good shape to withstand a moderate shock to prices. All in all, the scenario of further significant price drops is highly unlikely. Instead, a period of relatively stable house prices seems more likely, while past excesses are finally reabsorbed.

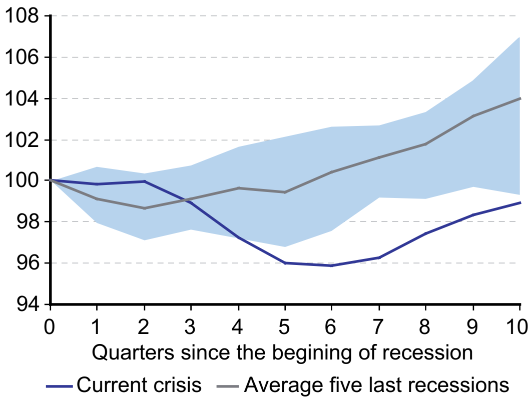
Overall, the drags on consumption and the low probability of further fiscal stimulus –out of concerns about the size of current deficits and the political arena, especially if there is a change in the balance of power after November's congressional elections– will be partially compensated by recovering private investment as sales improve and regulatory uncertainties diminish. This will imply an exit from the crisis in the US at a pace much lower than in previous cycles (Chart 3), as we have been forecasting for a long time. While the probability of a double dip in the US is low, in any case, the lack of strength of domestic demand will induce the US more and more to press the rest of the world (especially countries with a current account surplus and high domestic saving rates) to increase their demand and contribute to the necessary global rebalancing. The renewed monetary expansion in the US can be interpreted in this context as one way to force part of this adjustment onto the rest of the world.

Financial stress in Europe is still a source of concern, though systemic risk is lower than before the summer. Fiscal consolidation remains crucial to sustain confidence, and will not have a large negative impact on growth beyond the short-term

After decisive advances in fiscal consolidation, measures to provide support to distressed governments and especially after the financial sector stress tests, there has been a qualitative change in the dynamics of the crisis in Europe. Even if average sovereign spreads have remained relatively stable, markets have highlighted the differentiation between sovereign assets, thus reducing the risk of a systemic event. In addition, financial markets have started to open –though selectively– and renewed debt issuance is a further sign of lower tensions.

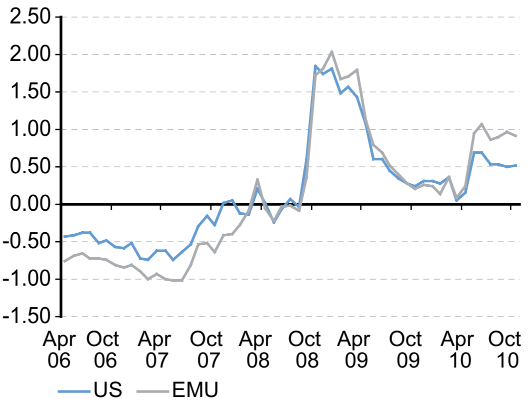
Notwithstanding this, financial market stress in Europe is still the main source of risk for the region (Chart 4) especially given the link between sovereign concerns and risks to the financial sector, given their national and cross-border exposure. In addition, the recent strengthening of the euro means an added challenge given that best performing economies had been supported by external demand. This makes it more imperative to tackle decisively in the short run the sources of macroeconomic vulnerability in the region, namely fiscal sustainability and external imbalances, as well as avoiding further de lays in restructuring the weak part of banking systems. The key is to continue rebuilding confidence to reduce market tensions and rebuild the autonomous strength of private sector demand. In addition, to sustain growth in the long run, it will be crucial to undertake much needed structural and institutional reforms, the latter especially geared towards preventing and resolving future fiscal imbalances. The focus on structural reform more than sustaining demand has been precisely the differentiating factor between the ECB and other central banks, prompting a less expansive stance than the Fed.

Chart 3
US GDP: current cycle vs. previous recessions*. Beginning of each recession=100



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

Chart 4
Financial Stress index



Source: BBVA Research

Monetary policy in advanced economies will be lax for a long time, adding pressure to exchange rates worldwide

Prospects of very low growth and subdued inflationary pressures in advanced economies will translate into low interest rates for a prolonged period in the three most important advanced areas (US, Europe and Japan). However, against the backdrop of renewed cyclical concerns and the much-reduced scope for further fiscal stimulus, markets were focused on the US embarking into a new bout of unconventional monetary easing (so-called Quantitative Easing 2, or QE2). The expectation of this further increase in liquidity lowered the exchange rate of the dollar across the board, including vis-à-vis the euro. Going forward, given that most of QE2 has been already priced in by markets, euro-dollar exchange rates will depend more on relative growth prospects (which favor the US vis-à-vis EMU) but also on the relative perception of monetary policy in both areas and the evolution of investment flows. At the same time, we expect appreciating pressures on emerging economies to continue due to increased global liquidity, stronger macroeconomic fundamentals and positive return differentials favoring renewed capital inflows.

Emerging markets face increasing policy dilemmas from strong growth, abundant global liquidity and neighbours' foreign exchange interventions

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. Going forward, growth in Asia will slow down because of a reduction in momentum from the ending of the global inventory cycle, weaker external demand and a withdrawal of policy stimulus, thus reducing the risk of overheating. But the region will continue to contribute the most to global growth.

Both Asia and Latin America confront increasing monetary and exchange-rate policy dilemmas, between cooling strong domestic demand and preventing strong capital inflows and preserving competitiveness in foreign markets. Some countries have started introducing administrative measures to discourage strong capital inflows and some others have slowed their rate of monetary tightening.

Given the relative 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, to the point that further exchange-rate appreciations will start to be a problem for growth. Thus, many countries in the region are weighing further exchange rate interventions although experience shows that their effectiveness if rather limited, contributing mostly to slow down the rise in exchange rates, but not prevent them. The risk is that increased intervention into foreign exchange markets ends up sliding into retaliatory trade measures. This highlights the importance of increased exchange rate flexibility in Asia (China, in particular) as a way to provide more policy space to the rest of the world.

2. A pause (not a double dip) in US activity

The US economy will slow down as expected, due to ongoing household deleveraging and high unemployment

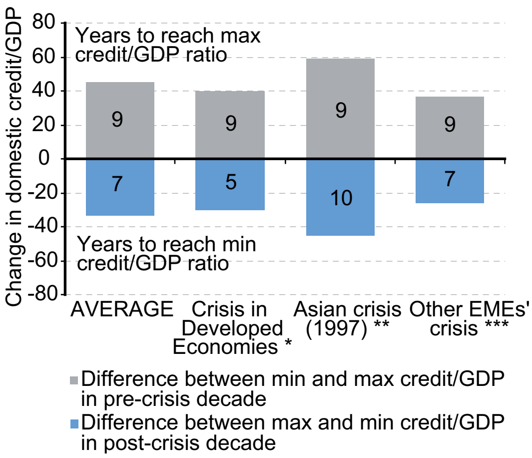
Strong growth in the US at the beginning of 2010 has lost momentum through the second and the third quarter of 2010, leading to renewed fears of a "double dip" among market participants. These concerns about the cyclical state in the US have compounded the financial woes still dominating in Europe, where macroeconomic and financial adjustments are still pending. Both factors are drawing much of the market attention, particularly for those who were expecting a "V" shaped recovery, and have generated uncertainty and thus volatility. In the end, this reflects the delicate position of the economy: firms are reluctant to hire on account of poor sales prospects, while consumers are cautious to spend given the fragile labor market conditions and ongoing deleveraging.

However, in our view the current US slowdown is likely to be nothing more than a pause in the pace of gradual recovery. A moderate recovery over the next few years was already the most likely scenario to be expected and the one BBVA Research favoured in its projections. Although the recovery has lost momentum a bit abruptly, (mostly as a consequence of the extensive data revisions for 2007-2010), it is consistent with a deceleration in the fast pace of growth that the US economy recorded in the first quarter of the year. Several factors were behind this projection. As fiscal policy measures are withdrawn, it was to be expected that the dynamism of the private demand would prove to be weak. This has been very clear in some key sectors that had benefited directly from fiscal support through incentives for purchases, such as durable goods (cars). The same can be observed in the housing market that showed a weak performance since the tax credit expired.

The loss of momentum in private demand is clearly the result of an ongoing household deleveraging process and a weak labor market. Although the deleveraging process evolves broadly in line with expectations, past US and international experiences suggest (Reinhart and Reinhart, 2010) that it takes a while to unwind previous debt increases (an average of 7 years) and credit ratios tend to drop as much as the fast increase previous to a financial crisis (see Chart 5). This is surely longer and deeper than what has been experienced so far. The reduction in debt levels, together with reduced household wealth, weak labor income and increased uncertainty will imply higher saving rates than those observed since the second half of the 1990s (Chart 6). Even though this goes in the right direction for the rebalancing of the US growth model, it increases cyclical concerns since consumption (one of the pillars of recovery in past recessions) will remain muted and only partially compensated by stronger investment in equipment by firms and stronger exports.

Chart 5

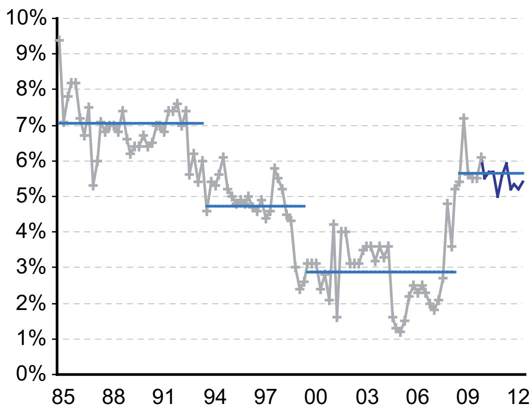
Domestic bank credit/GDP 10 years before and after severe financial crisis



* Spain (1997), Norway (1987), Finland (1991), Sweeden (1991), Japan (1992); ** Indonesia, Korea, Malaysia, Philippines, Thailand; *** Argentina (2001), Chile (1981), Colombia (1988), Mexico (1994), Turkey (2001)
Source: BBVA Research based on Reinhart and Reinhart (2010).

Chart 6

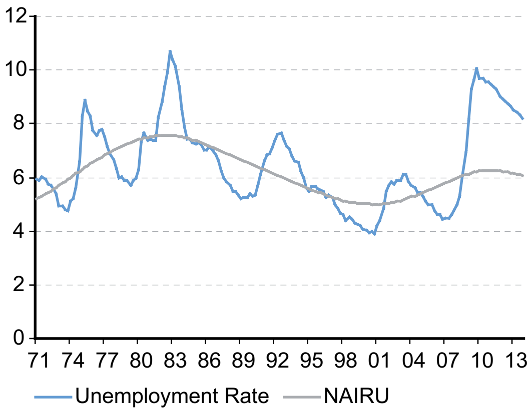
US: Saving rate



Source: BBVA Research

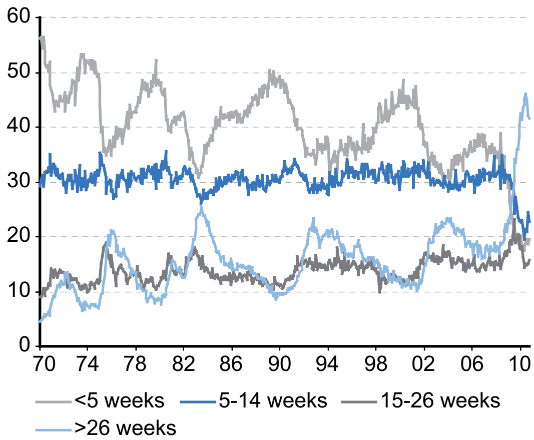
Another factor determining a slow exit from the recession in its own right is the poor performance of the labor market, with weak job creation and a high unemployment rate. The intense debate inside the Fed about what part of the increase in unemployment is structural and which part is due to weak demand highlights the uncertainty surrounding measures of structural unemployment. A number of elements point to an increase in structural unemployment of about 1.5 percentage points relative to pre-crisis levels (chart 7). First, high long-term unemployment (chart 8) erodes labor skills and rapidly adds to structural unemployment. Second, labor relocation currently is slow given skill and geographical mismatches and the structural change underway in the US economy. Finally, geographical mobility is currently impaired by the weak housing market, which makes it difficult for homeowners to sell their house and relocate, especially if they have negative housing equity. In any case, as chart 7 shows, the cyclical component of unemployment is still very high compared with previous recessions and expected to remain so for quite some time, justifying policies to prop-up aggregate demand if there is space to do so.

Chart 7
US: Unemployment Rate



Source: BBVA Research and Bureau of Labor Statistics

Chart 8
US: Unemployment duration (% of those unemployed)



Source: BBVA Research and Bureau of Labor Statistics

Recent concerns about the health of the housing sector in the US are excessive. The possibility of further house price drops is very small

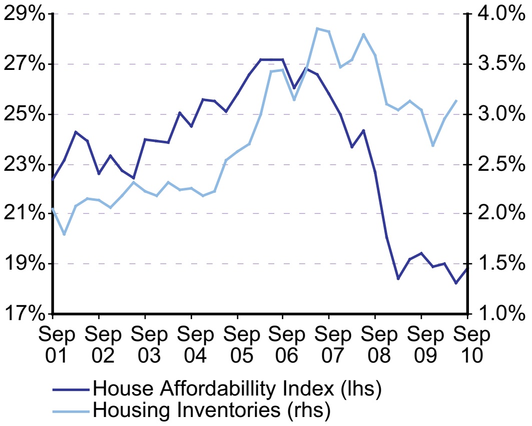
One important determinant of the evolution of US activity is the health of the housing market. In previous recessions, housing investment has been one of the main contributors to growth in the first quarters of the recovery, but in the current cycle housing investment has remained relatively muted, and will remain abated for some time while past excesses are reabsorbed. Recently there have been renewed fears of further weakness in the housing market and the possibility of further price drops that could drag confidence and have an impact on the banking system.

There are indeed some elements for concern in the housing market. The inventory of unsold houses, though 37% lower than two years ago, remains elevated, at roughly 8 months of sales (Chart 9). Furthermore, as chart 10 shows, there is the risk of a significant pent-up supply of future houses for sale coming from seriously delinquent mortgages (more than 90 days past due). Loan restructurings are surely helping dampen pressures from foreclosures, but these restructurings might just be delaying foreclosures as 60% of modified loans have redefaulted, due to still high debt-service ratios. These redefaults on modified loans could imply even higher inventories in the future, currently not captured by delinquencies nor foreclosures. Finally, there is the risk of further unexpected increases in supply coming from owners walking away from negative housing equity.

But there are also two elements of support for house prices. The first one is big gains in housing affordability (chart 7) explained by lower interest rates, the correction in house prices and higher household income. The second is strong demographic trends, since current age-distribution implies that household net growth (1.1 million new households per year) will surpass population growth. In addition, housing replacement rates are higher than in other developed countries and the trend is increasing. All these elements should help prop up demand going forward and contribute to set a floor in prices.

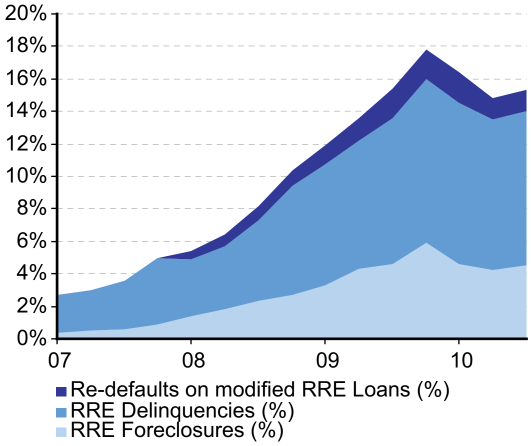
Thus, the scenario of further price drops is unlikely and instead a protracted period of relatively stable house prices seems more likely. In any case, recent stress testing shows that the US banking system should be able to withstand a moderate correction in real estate prices.

Chart 9
US: Housing inventories* and house affordability index**



* Percent of housing stock
** Mortgage payments to household income
Source: BBVA Research and Bureau of Labor Statistics

Chart 10
US Residential real estate: foreclosures and delinquencies



Source: BBVA Research and IMF

A double dip in US economic activity is highly unlikely

As noted before, the labor market is a sign that aggregate demand is still very weak in the US, and the pace of recovery will still be dependent on the room for further policy measures. On the fiscal front, there is not much left to spend from ARRA stimulus and it is unlikely to be extended, as room for further fiscal policy is scant –out of concerns about the size of current deficits and especially if there is a change in the balance of power after November's congressional elections–. However, the Fed has become more worried about both activity and deflation risks and pressure to react has increased significantly, as the cost of such scenario is perceived as "unacceptable". As the pace of recovery in output and employment has slowed in recent months, household spending remains constrained and inflation continues to come out lower than originally expected, the Fed will embark on further quantitative easing measures (see section 4) that will keep interest rates low and help sustain private sector demand.

On the other hand, the rebound of external demand and the recovery of the automobile sector have supported a widespread recovery of industrial activity and investment in equipment and software. In this environment, companies carried out mass layoffs that allowed them to increase productivity, reduce labor costs and, defend margins and profits. As sales prospects improve and regulatory uncertainties diminish, private investment will provide support for aggregate demand.

All in all, the drags on consumption and the low probability of further fiscal stimulus –partially outweighed by stronger investment– imply an exit from the crisis in the US at a pace much lower than in previous cycles, as we have been forecasting for some time. But the possibility of a double dip in the US is highly unlikely. Our models indicate a very low probability of a double-dip recession, although our monthly activity indices and models suggest below-par growth for several more quarters. However, we still foresee positive growth in the second half of 2010 (for a yearly growth of 2.7%). From 2011 onwards we project a gradual recovery with a slowdown to 2.3% in 2011 in the context of subdued inflation.

In any case, the lack of strength of domestic demand will induce the US more and more to press the rest of the world (especially countries with a current account surplus) to increase their demand and contribute to the necessary global rebalancing. The renewed monetary expansion in the US can be interpreted in this context as one way to force part of this adjustment onto the rest of the world.

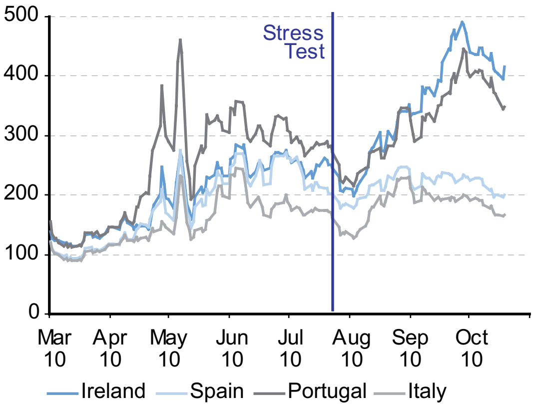
3. Still concerned about financial tensions in Europe

After decisive advances in fiscal consolidation and the release of bank's stress tests, there has been a qualitative change in the dynamics of the crisis in Europe, with increased differentiation

As we have stated repeatedly in the past, in 2010 fiscal policy turned from an element of support to domestic demand and the financial sector to being the cause of financial and cyclical risk. In this context, decisive actions geared towards fiscal consolidation (sometimes even accelerating the adjustment path planned at the beginning of the year), the creation of European support facilities for distressed governments and especially the carrying of Europe-wide stress tests for financial institutions changed the dynamics of the crisis at the end of the summer.

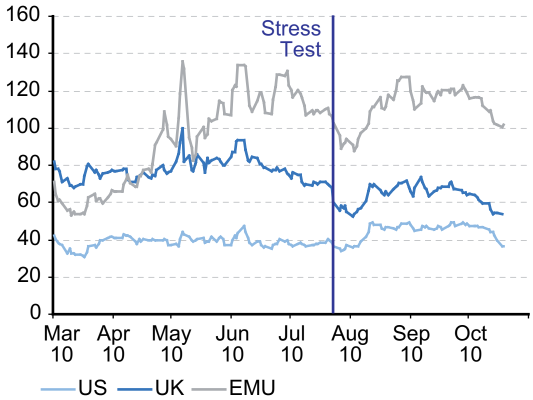
Indeed, markets have started to differentiate among sovereign assets and reflect better underlying macroeconomic and financial sector fundamentals, in contrast to the dynamics before the stress tests, where risk aversion was the main driver of spreads (see chart 11 and 12) and access to markets was also severely impaired. Greece has seen its sovereign spreads diminish since the end of October, given the strong commitment of European institutions and IMF and improvements in the fiscal front –a lower 2010 fiscal deficit and more ambitious deficit targets for 2011 than outlined in the EU-IMF programme–, although it still retains the highest sovereign risk in the EMU. The Irish situation is still weak due to doubts about the real cost of bailing out the banking system, whose size is extremely high (6.5 times Ireland's GDP) and where solvency problems –concentrated on big institutions– are still a concern. Nevertheless, the fact that Ireland does not need to refinance sovereign debt until mid 2011 reduces much short-term pressure from markets. On a longer horizon, Ireland also seems to have more space to implement further fiscal measures (especially given its relatively low tax burden) and the external adjustment is essentially completed. Finally, in Portugal, financial woes will remain driven partly by public deficit figures falling below target and the uncertainty about the political process to approve new measures aimed at reducing the deficit to the 4.6% target established for 2011.

Chart 11
Sovereign CDS spreads in European peripheral countries



Source: Bloomberg and BBVA Research

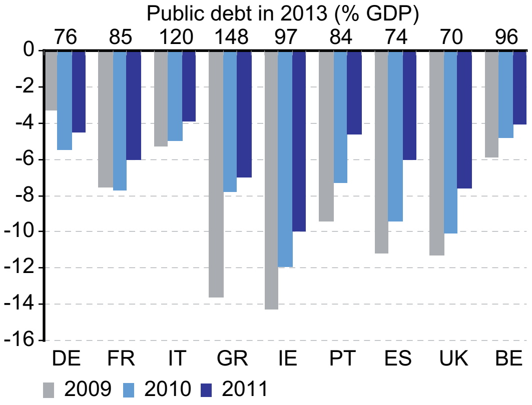
Chart 12
Sovereign CDS spreads in advanced economies



Source: Bloomberg and BBVA Research

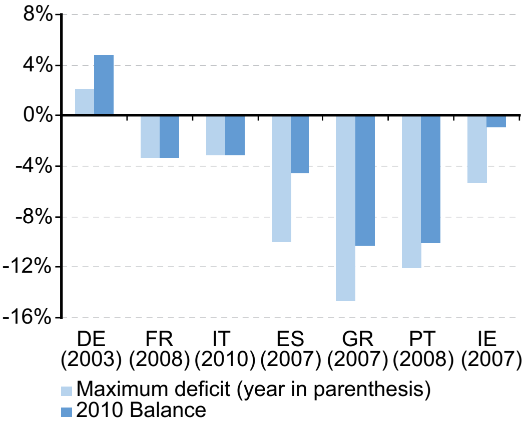
These developments are in stark contrast with the case of Spain. As we pointed out in our previous Global Economic Outlook, stress tests in Spain were more transparent (including all financial institutions) and assumptions about the macroeconomic scenario and pre-impairment income were more severe, lending it more credibility. In addition, the size of the financial system (3.2 times GDP) is much lower than Ireland's, and liquidity concerns are smaller than in the other three countries. Finally, fiscal and external adjustments (Charts 13 and 14) have also been bigger than in other peripheral countries, increasing the chances of a successful correction of previous imbalances.

Chart 13
Projected deficit plans (% GDP)



Source: BBVA Research and National sources

Chart 14
Current account balance



Source: BBVA Research and AMECO

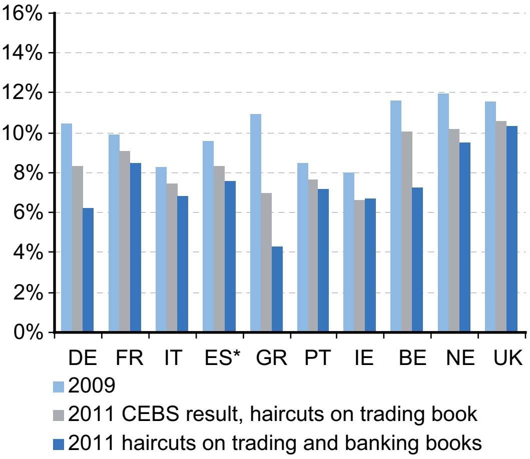
However, financial market tensions are still the main source of risk for Europe

In addition to this increased differentiation in prices, financial markets have started to open –though selectively– and renewed debt issuance is a further sign of lower systemic tensions. Notwithstanding this, sovereign spreads in Europe are still high (chart 12) and, despite the efforts to contain and reduce the deficit, peripheral countries face high sovereign and private funding needs in coming years, in the context of very low growth (real and nominal).

The extent to which sovereign exposures might end up affecting the banking sector is illustrated by BBVA calculation shown in chart 15, where haircuts applied to sovereign debt holdings in the trading book of financial institutions (i.e. the exercise carried out in European stress tests) have been also applied to sovereign debt holdings in the banking book (something not done under the stress tests). This obviously results in much lower Tier 1 capital ratios for the biggest financial institutions in each country. Although this is of course an extreme event since assets in banking books are held to maturity, it illustrates the differential exposure of EMU banking systems to sovereign debt, with Germany, Greece and Belgium seeing the biggest reduction in capital due to their higher exposure.

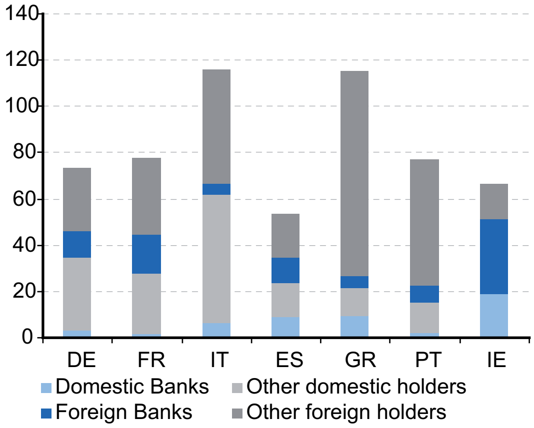
Thus, financial market stress is still the main source of risk for the region given the link between sovereign concerns and risks to the financial sector, due to their domestic and cross-border exposure, especially in peripheral countries. Indeed, chart 16 shows that the majority of sovereign debt in Ireland is held by banks, much of it foreign, but still a sizable proportion is held by domestic institutions (as is the case, to a lesser extent, in Greece, Spain and Italy). But it is also important to highlight that the majority of sovereign debt in many European countries is held by foreign investors, more influenced by market sentiment.

Chart 15
Average Tier 1 ratios after stressing sovereign exposure



* Six largest institutions
Source: BBVA Research using CEBS data

Chart 16
Sovereign debt holders in selected European countries (% of GDP)



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

In addition renewed euro appreciation adds a challenge for European recovery

In addition, the recent strengthening of the euro means an added challenge to the EMU, especially in 2011, given that the best performing economies had been propped up by external demand. Thus, it is of utmost importance to address the sources of reduced confidence in the region, namely high and increasing public debt and weak banking systems. In the first case, the credibility of ongoing fiscal consolidation plans should be reinforced, ensuring that previously agreed fiscal deficit targets are met to reduce them below 3% of GDP in 2013-14. In the second case, after the publication of financial system stress tests, weak and vulnerable banks need to be recapitalized, restructured or resolved, but progress has been uneven across countries.

Therefore, it is crucial to re-focus on structural and institutional reforms

In addition, to sustain and increase growth in the long run, it will be crucial to focus even more on much needed structural and institutional reforms. In the first case, further EU-wide liberalization of product and service markets will increase productivity, and in many European countries increased flexibilization of labor markets and the upgrade of education systems is also essential. But also very important is the task of reforming EU institutional frameworks, to deal with crisis prevention and resolution, calling for a stronger role at the EU level and stronger incentives for countries to pursue sound policies. However, recent negotiations underway appear to be tilting crisis prevention frameworks to a system of decisions taken by qualified majority voting (instead of automatic procedures), which bring it too close to the former non-biting stability and growth pact. More advances seem underway for crisis resolution mechanisms, with the possibility that the European Financial Stability Facility be replaced by a European Monetary Fund after three years.

Thus, given the challenges stemming from fiscal consolidation, recovering confidence in the financial system and restructuring of banking systems, Europe will continue to face a relatively slow recovery in the whole area. However, there will also be significant differences between European core countries and those of the periphery. Core countries have accumulated less imbalances during the expansionary years and are benefiting the most from the pull of external demand (mainly from the emerging world). But it is also clear than even in core countries the recovery will not be self-sustaining if the impulse from external demand does not translate into a firm recovery in consumption and investment, something that is not clearly in sight yet. This seems to be in line with ECB reasoning, more focused on the need of structural reform in Europe, and thus being less expansive than the Fed.

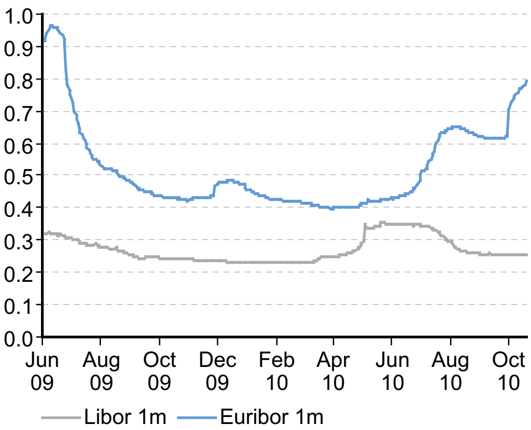
4. Global spillovers from very lax monetary policy

A new bout of Quantitative Easing (QE2) in the US

The Fed sounds increasingly concerned about the economic outlook and worried by deflationary pressures in the US. Recent communication has set the groundwork for further monetary easing by clearly stating that current economic conditions are inconsistent with the Fed's dual mandate. Further, they have made explicit the Fed's objective for inflation and unemployment and stated that inflation is too low while unemployment is too high and the short term real interest rate is too high.

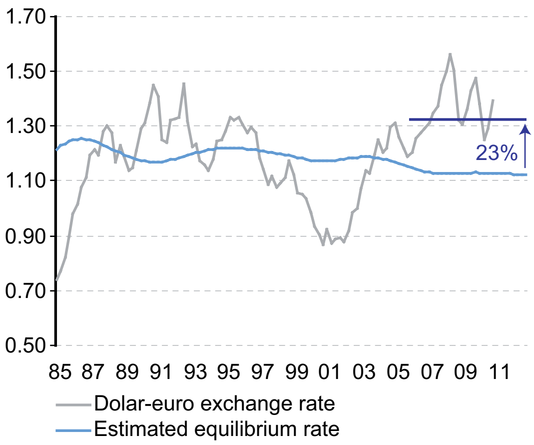
But with nominal interest rates already quite low (Chart 17), the Fed will try to reduce the term premium in the yield curve to prompt investors to shift to other assets, helping to avoid the liquidity trap. Most likely starting in November, the Fed will continue to implement unconventional monetary easing policies, primarily through balance sheet expansion (QE2). Most probably the Fed will announce a final target number which we estimate around 1 trillion dollars, due to concerns about financial stability and the macroeconomic outlook. In contrast with the prior round of QE, with QE2 the Fed will proceed with some caution –implementation will be continuous but in small steps–and on a more adjustable basis –conditional on the evolution of the Fed's economic forecasts–. The current established pattern of pre-announced monthly targets (to maintain the size of the balance sheet) will likely continue under a new Large-Scale Assets Purchases (LSAP) program. Our estimate is that initially monthly goals will be close to 65bn dollars. Whether a new round of asset purchases will be effective in stimulating economic activity is still a very open question, especially through changes in relative asset prices. First, there is wide uncertainty about the size of the effect of Treasury purchases on long term yields. Academic studies point to a reduction in 10-year yields in between 13 and 67 basis points for a 1 trillion programme of bond purchases. Second, the effectiveness in stimulating economic activity will depend on how willing are investors to switch to riskier assets (more in line with expanding economic activity) given the reduction in bond yields. All in all, we expect this programme to provide some support for investment (but not much for consumption, given muted wealth effects) and net exports, through a lower exchange rate for the dollar.

Chart 17
Short-term interest rates (%)



Source: Bloomberg and BBVA Research

Chart 18
Dollar-euro exchange rate and estimated equilibrium level



Source: BBVA Research

Other central banks could be forced to follow

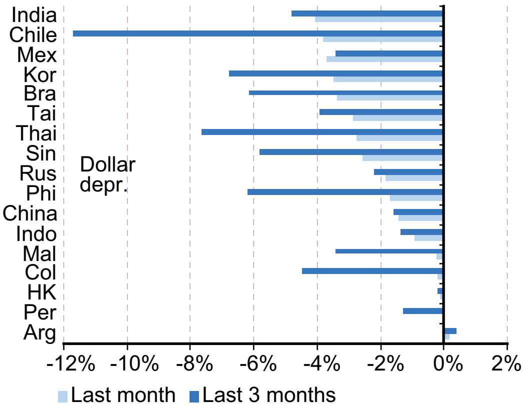
Possibly, as the Fed moves toward a new round of easing (QE2) other central banks will be strained to adjust their monetary policy stances. In the current global economic context with a shortage of demand, countries will likely be forced to follow Fed's actions in order to prevent unwanted currency appreciation. The Bank of Japan (BoJ) has already decided to step up monetary easing and the Bank of England (BoE) could follow.

How other central banks react from here will depend on the evolution of the global economy and the value of their currencies. Currently the European Central Bank (ECB) has a more hawkish stance and seems opposed to further easing. The ECB has had a different communication strategy and has not yet revealed the internal debate that exists in monetary policy. We consider that the ECB ought not to remain indifferent to the recent strength of the euro as it could damage EMU's growth. Over the last five years, the euro/dollar exchange rate has averaged 1.34, which considering our estimated equilibrium exchange rate, implies a persistent overvaluation of about 20% (see Chart 18). Prolonged currency misalignments such as this have not been sustainable over time. In addition, the ECB is expected to start making some changes in their wording, but other options could also be considered. Going forward, given that most of QE2 has been already priced in by markets, euro-dollar exchange rates will depend more on relative growth prospects (which favor the US vis-à-vis EMU) but also on the relative perception of monetary policy in both areas and the evolution of investment flows.

Under free-floating exchange rate regimes, most emerging currencies are facing strong appreciation pressures as the Fed moves to QE2. Excess liquidity is causing an important increase in flows to emerging markets; the effect on currencies is noteworthy (see Chart 19). As chart 20 shows, this pressure has led to a rise in the pace of reserve accumulation across emerging market economies as central banks are trying to offset the dollar decline. Accumulation of foreign exchange reserves in the last few months has risen appreciably relative to previous quarters and to the average pace in the past two years. Yet, these measures have not succeeded. Some countries can initially offset appreciation pressures, but additional efforts are difficult as they generate sterilization problems. In countries with deeper financial markets, even with other capital control measures (e.g. Brazil's increase in the IFO tax to 6%), efforts will prove ineffective. Up to now, central banks in emerging economies have tried to avoid further appreciation in their currencies by either stopping or slowing their monetary tightening.

Chart 19

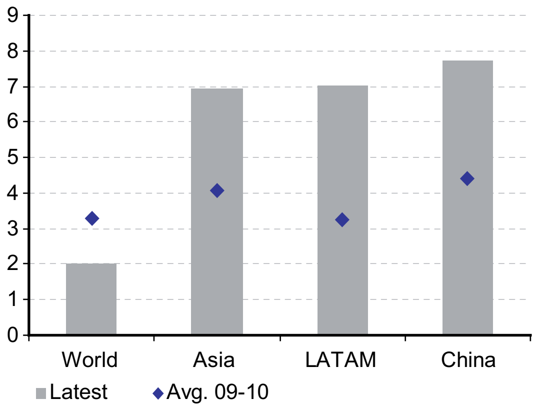
US dollar exchange rate changes against emerging currencies (% change)



Source: Datastream and BBVA Research

Chart 20

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



Source: Bloomberg and BBVA Research

The allowed pace of revaluation in the renminbi holds the key to other central banks' reactions

This reasoning leads us to conclude that China's fixed exchange rate regime and the allowed pace of revaluation in the renminbi (RMB) going forward holds the key for the timing and extension of monetary policy actions of central banks across the world. China has allowed relatively little currency appreciation over the past year, even in the face of strong inflows and further reserve accumulation. Since the re-adoption of a more flexible exchange rate framework in June this year, the RMB has appreciated by only 2.7% against the dollar. Our baseline scenario anticipates further gradual appreciation of the RMB –about 4-5% for the year as a whole by year-end.

We believe the authorities in China recognize that currency appreciation is beneficial to the economy, particularly as it supports their ongoing efforts to rebalance growth toward domestic sources and to boost private consumption. Nevertheless, we view the prospects for a significant acceleration in the pace of revaluation to be low, given the authorities' preference for gradualism, concern about the strength of the global recovery, and fears of generating speculative capital inflows. Therefore, reserve accumulation in China may continue or even accelerate, thereby putting pressure on floating currencies. In this setting, the ECB will probably be forced to change its communication strategy. Central banks in emerging markets would probably have to step up their interventions in foreign exchange markets to avoid unwanted further appreciation. Interventions could be left unsterilized –with the exceptions of Mexico and Peru, which face sterilizing problems– and lead to an easing in monetary policy. Additionally, further capital control measures are likely in many Asian countries, and probably in some Latin American countries, particularly in Brazil. Lastly, additional credit control measures would be likely in countries with significant strength in economic activity (e.g China, India and Peru).

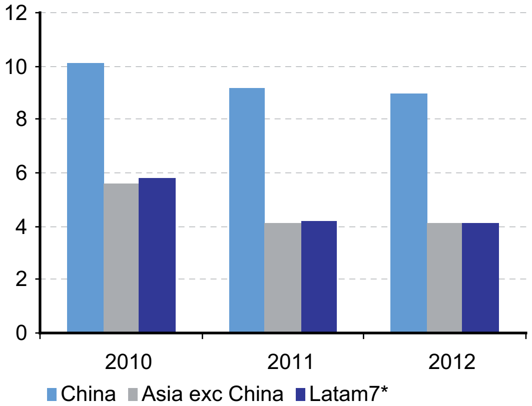
Our view is that these interventions will likely smooth the appreciation trend, but will not cause a reversion of exchange rates to previous levels. In this sense, appreciation will consolidate. Appreciation pressures will continue both in Asia and LatAm but at a gradual pace as a result of interventions. Our perspective is that there is still room, albeit not much, for further appreciation considering the abundant liquidity, high returns and low risk. Nonetheless, the currencies that have appreciated the most recently (e.g. the Brazilian real) show some initial signs of misalignment and in turn, will appreciate less going forward. Finally, although less likely, a sharper appreciation of the RMB would lower the pressure on most floating currencies.

5. Increasing policy dilemmas in emerging economies

Emerging economies will continue to grow strongly

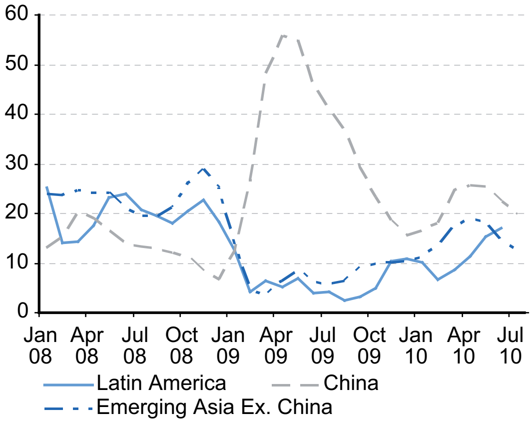
Emerging economies in Asia and Latin America, continue to grow strongly (chart 21), leading the global recovery. In both regions fixed investment has increased substantially, even as inventory accumulation and the policy stimulus are receding as the main source of dynamism. Thus, the transition from public to private source of demand growth seems to be running relatively smoothly. Going forward, growth in Asia will slow down –and reduce the risk of overheating– because of a reduction in momentum from the ending of the global inventory cycle, weaker external demand and a withdrawal of policy stimulus. In addition, China will keep reigning on strong domestic credit (Chart 22). But the region will still contribute the most to global growth, with China and India being the biggest contributors pulling the global economy out of the global recession. In Latin America, the recovery is led by Brazil (with some risks of overheating) but growth is strong in most of the region, benefiting from the rebound in global trade and its increasing links to Asia. Going forward, the region will retain most of its dynamism, with only a moderate slowdown from strong growth rates in 2010.

Chart 21
Emerging economies GDP growth (%)



* Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela
Source: BBVA Research

Chart 22
Growth of credit to the private sector (%y-o-y)



Source: BBVA Research and IMF

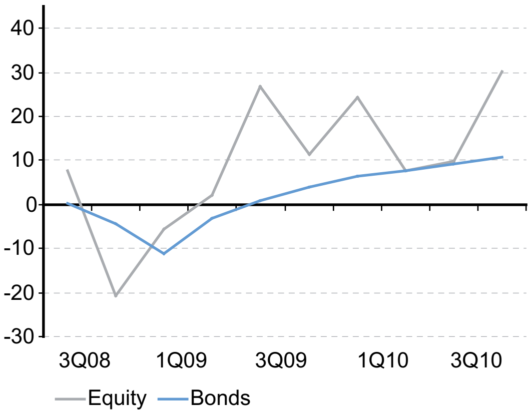
Strong capital inflows and dynamic domestic demands pose increasing policy dilemmas for emerging economies. Asian exchange rate inflexibility pushes a significant part of the adjustment onto Latin America

With growth slowing down in advanced economies and lower global risk aversion, emerging countries have become more attractive as a destination for portfolio flows (see Chart 23) given their sound macroeconomic fundamentals and higher potential growth rates. This shift in asset allocation is likely to remain as long as these differentials persist. But the build-up of macro-financial risks in the form of increased volatility and excess domestic demand is also tied to these massive inflows of capital. As mentioned before, some countries have started introducing administrative measures to discourage strong capital inflows and some others have resorted to currency interventions and have slowed their rate of monetary tightening, risking domestic overheating. Indeed, intervention to reduce exchange rate volatility and stem currency appreciation seems to be broadly the case in Asia, where exchange rates have appreciated less than in Latin America, especially in nominal but also in real effective terms (see Chart 24).

Given the inflexibility of exchange rates in Chjna (and, to a lesser extent, in the rest of emerging Asia), Latin America is facing a significant part of the adjustment, to the point that further exchange-rate appreciations (around 15% in real effective terms in the last 2 years) will generate sizable departures from equilibrium exchange rates in some countries (Brazil and Colombia being the most misaligned) and start to be a problem for growth. This will not be acceptable, prompting more exchange rate interventions in the region and the introduction of outright capital controls. However, experience shows that their effectiveness if rather limited, contributing mostly to slow down the rise in exchange rates, but not to prevent them in the medium term. However, the risk is that increased but ineffective intervention into foreign exchange markets ends up sliding into retaliatory trade measures. This highlights the importance of increased exchange rate flexibility in Asia (especially China) as a way to provide more policy space to the rest of the world.

Chart 23

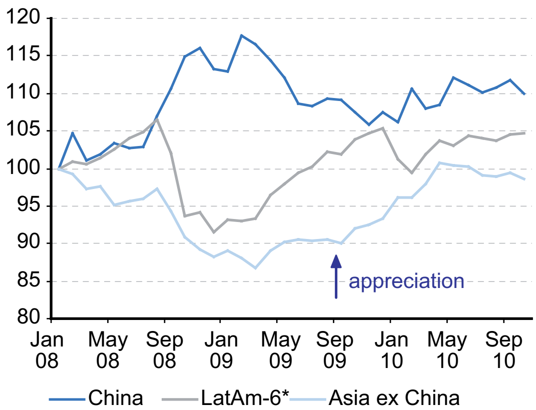
Capital flows to emerging economies (USD bn)



Source: EPFR and BBVA Research

Chart 24

Real effective exchange rates (index Jan 2008 = 100)



* Argentina, Brazil, Chile, Mexico, Peru and Venezuela
Source: BIS and BBVA Research

6. Tables

Table 1

Macroeconomic Forecasts: Gross Domestic Product

(YoY growth rate)	2007	2008	2009	2010	2011
United States	2.1	0.4	-2.6	2.7	2.3
EMU	2.9	0.3	-4.0	1.6	1.2
Germany	2.8	0.7	-4.7	3.2	1.8
France	2.3	0.1	-2.5	1.6	1.4
Italy	1.4	-1.3	-5.1	1.1	0.8
UK	2.6	-0.1	-4.9	1.7	1.9
Latin America *	5.8	4.0	-2.4	5.8	4.2
Asia	7.6	4.2	2.0	6.8	5.5
China	14.2	9.6	9.1	10.1	9.2
Asia (exc. China)	5.2	2.1	-0.7	5.6	4.1
World	5.3	3.0	-0.6	4.7	4.1

Forecast closing date: 29th October 2010
* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
Source: BBVA Research

Table 2

Macroeconomic Forecasts: Inflation (Avg.)

(YoY growth rate)	2007	2008	2009	2010	2011
United States	2.9	3.8	-0.3	1.6	1.2
EMU	2.1	3.3	0.3	1.6	1.7
Germany	2.3	2.8	0.2	1.1	1.3
France	1.6	3.2	0.1	1.7	1.6
Italy	2.0	3.5	0.8	1.6	1.8
UK	2.3	3.6	2.2	3.1	2.8
Latin America *	5.3	7.7	6.4	6.5	6.3
Asia	2.9	5.1	0.3	2.8	2.8
China	4.8	5.9	-0.7	3.0	3.3
Asia (exc. China)	2.2	4.8	0.7	2.8	2.6
World	4.1	6.1	2.2	3.6	3.5

Forecast closing date: 29th October 2010
* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
Source: BBVA Research

Table 3

Macroeconomic Forecasts: Current Account (% GDP)

	2007	2008	2009	2010	2011
United States	-5.2	-4.9	-3.0	-3.7	-3.9
EMU	0.1	-0.9	-0.6	-0.5	-0.2
Germany	7.9	6.6	5.0	4.8	4.8
France	-2.3	-3.3	-3.0	-3.4	-3.6
Italy	-2.4	-3.1	-3.1	-2.9	-2.6
UK	-2.7	-1.3	-1.1	-1.6	-1.3
Latin America *	0.7	-0.5	-0.3	-0.7	-1.3
Asia	5.6	4.1	3.6	3.5	3.5
China	10.9	9.6	6.0	5.6	5.1
Asia (exc. China)	3.6	2.1	2.7	2.7	2.9

Forecast closing date: 29th October 2010
* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
Source: BBVA Research

Table 4

Macroeconomic Forecasts: Government Deficit (% GDP)

	2007	2008	2009	2010	2011
United States	-1.2	-3.2	-9.9	-10.7	-8.5
EMU	-0.6	-2.0	-6.3	-6.2	-5.1
Germany	0.2	0.0	-3.3	-3.9	-3.0
France	-2.7	-3.3	-7.5	-7.6	-6.5
Italy	-1.5	-2.7	-5.3	-5.0	-4.3
UK	-2.8	-4.9	-11.5	-9.9	-8.2
Latin America *	-0.7	-1.0	-3.0	-2.2	-2.0
Asia	-0.3	-2.4	-5.2	-5.4	-4.7
China	2.2	-0.4	-2.2	-2.9	-1.9
Asia (exc. China)	-1.3	-3.8	-6.3	-6.4	-5.7

Forecast closing date: 29th October 2010
* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
Source: BBVA Research

Table 5

Macroeconomic Forecasts: 10-year Interest Rates (Avg.)

	2007	2008	2009	2010	2011
United States	4.6	3.6	3.2	3.0	2.4
EMU	4.2	4.0	3.3	2.7	2.4

Forecast closing date: 29th October 2010
Source: BBVA Research

Table 6

Macroeconomic Forecasts: Exchange Rates (Avg.)

US Dollar per national currency	2007	2008	2009	2010	2011
United States (EUR per USD)	0.7	0.7	0.7	0.8	0.8
EMU	1.4	1.5	1.4	1.3	1.3
UK	2.0	1.8	1.6	1.6	1.6
China	7.6	6.9	6.8	6.5	6.3

Forecast closing date: 29th October 2010
Source: BBVA Research

Table 7

Macroeconomic Forecasts: Official Interest Rates (End period)

	2007	2008	2009	2010	2011
United States	4.3	0.6	0.3	0.3	0.3
EMU	4.0	2.5	1.0	1.0	1.0
China	7.5	5.3	5.3	5.6	6.1

Forecast closing date: 29th October 2010
Source: BBVA Research

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