BBVA Research

Global

Economic Outlook

First Quarter 2011

Economic Analysis

- The world will continue its decoupling, both growth and policy wise.
- Emerging economies continue to lead global growth. At the same time, growth in the main advanced economies picks up, but fragilities remain.
- As we expected, chances of a double dip scenario in the US have faded. The risk of higher interest rates in the long-run becomes more relevant.
- Institutional and economic reforms in Europe will be crucial for solving the financial crisis.
- Commodity prices will level off, but nonetheless inflation risks are becoming more relevant in emerging economies, which will continue to grow strongly.

Index

Closing date: February 4, 2011

1. Summary: decouplings at play

The world will continue on divergent paths, increasing growth and policy decouplings

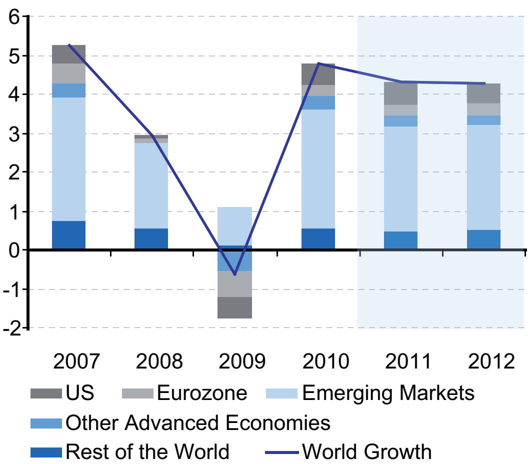
Growth continues to be strong. After closing 2010 with a growth rate of 4,8%, the global economy is expected to decelerate slightly to 4,4% both in 2011 and 2012, a better performance than what could have been anticipated 12 months ago. This is explained by a better outlook for advanced economies, due to (i) the better growth expectation for the US after the fiscal stimulus, and (ii) a strong performance in core European countries, which have decoupled from those of the periphery, dragged by financial market tensions. In fact, even though financial market tensions in Europe worsened during the last quarter of 2010, economic activity the region as a whole has been able to accelerate, thus showing –at least temporarily– a degree of decoupling also between the financial and the real side. Overall, the pattern of global economic growth remains broadly unchanged as the real engine of dynamism continues to be the emerging world, led by Asia (China and India in particular, see Chart 1), and developed economies continue losing ground, more in Europe than in the US.

All these decouplings have three important implications for the outlook. First, the divergence between growth in advanced and emerging economies will continue to induce markedly different macroeconomic policies going forward. Monetary policies will remain highly accommodative in the US and Europe, fuelling a search for yield elsewhere (in emerging markets and increasingly in commodities as well). At the same time, signs of overheating are starting to emerge in some countries in Asia and Latin America, pushing authorities to consider tightening policy faster than previously envisioned given incipient inflationary pressures, especially in Asia (Chart 2). The resulting incentives for capital inflows into emerging economies will intensify policy dilemmas already present in both regions, between tightening policy to ensure a soft landing and preventing sudden and sharp exchange rate appreciations.

Second, the growth divergence between the US and EMU will –together with financial risk– put downward pressure on the euro and, perhaps more significantly, will keep drawing market attention to the relative difficulty of the EMU to grow out of their high public debt levels. This is one of the elements –together with the different size of central banks' bond-purchase programs and the turmoil around economic governance in Europe– that explains why markets have not reacted significantly to a further postponement of fiscal consolidation in the US. The difference with market punishment to some countries in Europe could not be starker.

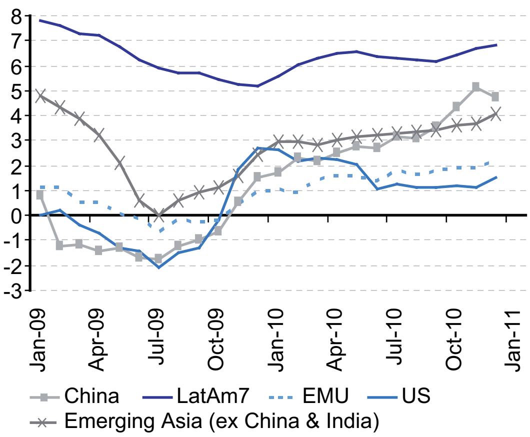
Finally, the increasing decoupling within the EMU will start straining the conduct of a common monetary policy for the region, already torn between an incipient risk of inflation, especially in core countries, and the need to continue supporting financial stability, especially –but not exclusively– in peripheral economies.

Chart 1
Global GDP growth and contributions



Source: BBVA Research

Chart 2
Inflation (yoy%)



Source: BBVA Research and Datastream

Growth in the major advanced economies has picked up, but fragilities remain. Chances of a double dip scenario in the US, which we thought were very low, have faded. But interest rate risks in the long-run now become more relevant

As we expected, the US did not fall into a double dip, and the chances of that happening in the future have faded since the summer. Four main factors have contributed to the change in sentiment regarding the outlook for growth in the US. First, better macro outturns at the end of 2010 signaled that household consumption was more resilient than was feared. Second, decisive action by the Federal Reserve, implementing and additional round of asset purchases (QE2) provided support for bond prices in particular, and asset prices in general. Third, reduced uncertainty and increased business confidence is expected to benefit investment. Finally, and perhaps more important, a new fiscal stimulus package, approved at the end of 2010, will provide a significant boost to economic growth. We have thus adjusted our growth forecast for 2011 by 0,7 percentage points, to 3%.

However, weaknesses have not disappeared. Real estate markets remain feeble and still prone to negative surprises. Household income is still sluggish given that the speed of the recovery will not be sufficient to significantly reduce unemployment rates. On top of it, credit growth and securitization processes remain subdued. While none of this should derail the recovery, it continues to configure a scenario in which an additional negative shock would harm the economy. For now, this outlook of gradual economic recovery with low inflationary pressures on the demand side, will permit monetary policy to remain accommodative for an extended period.

Moreover, the lessons from the sovereign crisis in Europe should not be forgotten. Granted, the new fiscal package at the end of 2010 had the benefit of boosting growth in the short-run, at the time when doubts about a double dip were still in the air. But one should not overestimate the strength and persistence of the factors that have prevented a negative reaction from bond markets to a further delay of fiscal consolidation in the US. Central bank bond purchases and the turmoil in Europe (and thus flight to quality to US bonds) are by nature short-run factors that will disappear in the medium run, and before that happens the US will need to show a clear commitment to fiscal consolidation or risk a sudden spike in long-term interest rates. Rating agencies have already started to signal this risk. There is time, but discussions and plans should start as soon as possible to reduce long term fiscal concerns.

Institutional and economic reforms in Europe will be crucial for solving the financial crisis

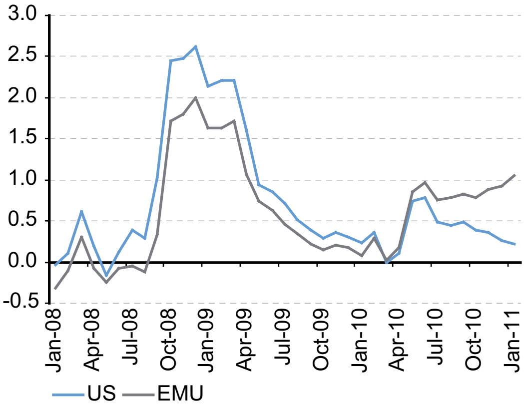
Since October 2010, financial tensions in Europe have surged again (Chart 3), especially in peripheral countries. Concerns about fiscal sustainability and financial sector losses resurfaced again, leading to widening sovereign spreads and funding pressures. However, contrary to the episode in May, financial spillovers to other countries in Europe and outside the EU were more limited.

The increase in financial market tensions was triggered by two events. First, markets were uncertain about the ability of European institutions to deal with sovereign debt crises. Private investors were spooked by the proposal that they would bear losses on possible restructurings after 2013, and the likelihood that haircuts on existing debt would be needed to restore fiscal sustainability. The second trigger was increasing doubts about the credibility of stress tests, given the need to support Irish banks shortly after they were deemed adequately capitalized. These two triggers developed amid the background of concerns about the capacity of some peripheral countries like Portugal and Ireland to fulfill their fiscal deficit targets and doubts about the ability of some European economies to generate enough growth momentum to make their debt burden sustainable.

The fragility of the recovery in financial markets right after the summer highlights that markets are increasingly focusing on sovereign solvency problems in some countries, rather than just liquidity concerns. This stresses the need for a comprehensive solution, both for solving this crisis, as well as establishing a sound crisis prevention and resolution mechanism for the future. For future crisis prevention, fiscal coordination needs to be reinforced, providing for shock absorbers for idiosyncratic shocks in individual countries, but also reinforcing surveillance both in the fiscal front and in the macroeconomic dimension (including preventing the build-up of private sector imbalances). For crisis resolution, a clear and transparent mechanism that defines those who will bear losses needs to be put in place, to avoid excessive market volatility due to uncertainty, but probably at this stage is extremely important to guarantee an adequate transition mechanism.

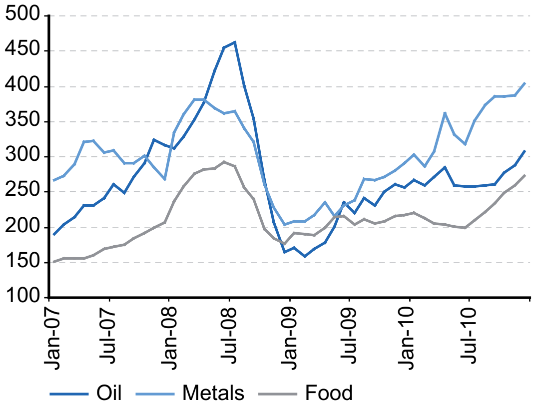
As pointed out above, financial spillovers from this recent episode have been rather limited, including to core countries in Europe. Thus, growth in the EMU as a whole was stronger than anticipated, especially due to very positive outturns in Germany and other core European countries. However, this decoupling between financial tensions in peripheral countries and real economic activity in Europe will not last if a comprehensive governance reform is not agreed soon and countries do not continue pushing economic reforms to reduce fiscal vulnerabilities, restructure the financial system and increase potential growth. What is agreed at the next European Council in March will be key in this respect.

Chart 3
BBVA Financial Stress Index



Source: BBVA Research

Chart 4
Commodity prices (2000=100)



Source: BBVA Research

Commodity prices will level off, but nonetheless inflation risks are becoming more relevant in emerging economies, which will continue to grow strongly

Commodity prices have surged across the board in recent months, reaching all-time highs in the case of some metal prices (Chart 4). This is consistent with what seems to be the beginning of a long-term upward trend in commodity prices driven by surging demand from emerging economies, but there are other short-run factors that have contributed to the recent surge, at least in some commodity classes. For instance, the very fast increase in food prices in the past two months is to a great extent the effect of one-time supply-side factors (weather disturbances), which should wind down during the rest of 2011. Moreover, given ample global liquidity conditions, investors have piled into commodities as an asset class, increasing financial premia across the board.

Going forward, we expect commodity prices in general to level off around current readings. In the case of food prices this will be the result of normalizing crops in 2011. For metals, elevated inventories will start to weigh on prices. Only in the case of oil we expect a tight market to continue pushing prices slightly higher in 2011 but gradually easing afterwards. This easing will be helped by a likely reduction in financial tensions in Europe, which should shift investment flows away from commodities into other assets with more contained risk premia. Nevertheless, risks are tilted to the upside, as strong demand in Asia will continue to support an upward trend in prices in the medium run.

The increase in commodity prices has been responsible, in part, for the increase in inflation observed in emerging economies at the end of 2010 (Chart 2). In particular, the increase in food prices has had a direct and important first-round effect on higher inflation in a number of countries –especially in Asia– with the risk of feeding into overall inflation. However, going forward, the expected leveling of food prices will mean that this factor should become less important in determining headline inflation. Although the risk has also increased in developed countries, it is smaller than in emerging economies, given that food prices have a smaller weight on CPI and ample unused capacity and anchored inflation expectations will help keep inflation pressures in check.

More worrying for emerging economies is the realization that rapid growth and strong capital inflows in Asia and Latin America are starting to generate overheating pressures, through inflation but also evident through rapid credit growth and increasing asset prices. Indeed, we expect Asian economies to continue growing strongly, although in our opinion authorities will be able to steer them to a soft landing and avoid overheating, although that is surely a more pronounced risk than three months ago. Driven by domestic demand and high commodity prices, Latin America is also poised to grow strongly in 2011, converging to potential growth of around 4% in the region. As mentioned before, the biggest challenge for both regions will be to manage the policy dilemmas generated by strong capital inflows. We expect policy to continue tightening in most countries, while at the same time imposing ever more stringent administrative controls to limit those inflows and prudential measures to limit credit growth, especially in Asia.

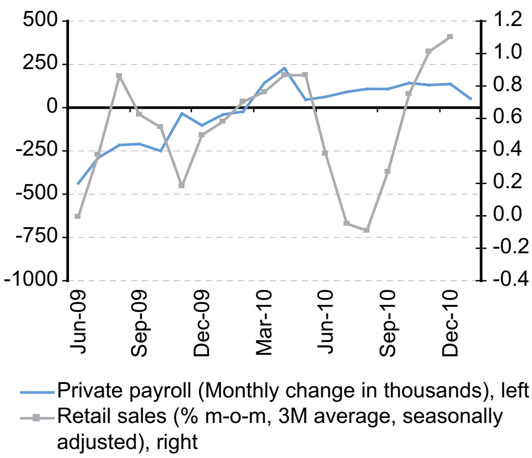
2. US outlook improves

As we had anticipated, the risk of a double dip scenario in the US is steadily fading as prompt measures have been taken and consumption proved to be more resilient than feared

In the summer of 2010 concerns arose about the cyclical momentum of the American economy, as the pace of recovery seemed to be decelerating more severely than initially expected. In fact, in the second quarter of 2010 the US economy barely grew 0.4% q-o-q from around 1% at the end of 2009 and the first quarter of 2010. We did not expect a double dip back then, but a slow recovery –far from being V-shaped – amid an ongoing process of household deleveraging, elevated housing inventories and thus continued pressure on prices and high and persistent unemployment rate.

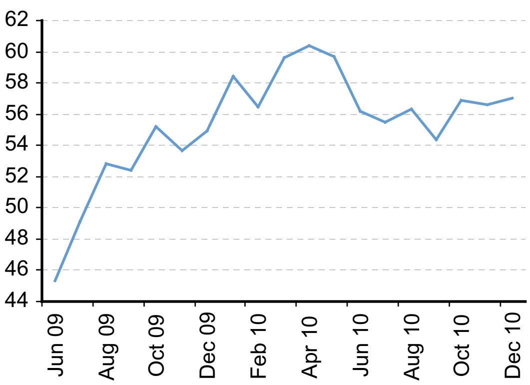
Over the last quarter of 2010, it seemed clear that the US was not falling into a double dip. The most recent data proves that the chances of that happening in the future, which we thought were very low, have faded. The change in sentiment regarding the US outlook has been one of the main features of the past quarter. There are, at least, four main factors that have contributed to this change. First, in general terms, data released over the last few months has come out better than expected; in particular consumption was more resilient than feared. At the same time, the labour market has been improving, albeit at a slow pace (Chart 5). Second, the Federal Reserve took decisive action by implementing an additional round of asset purchases (QE2) amid concerns over the pace of the American recovery, which provided support for bond prices in particular, and asset prices in general. Third, uncertainty about increased regulation and taxation has decreased, boosting business confidence and thus most likely investment in 2011 (chart 6). Finally, and perhaps more important, a new fiscal stimulus package (see Box 1), approved at the end of 2010, will provide a significant boost to economic growth in 2011 and 2012. We estimate the impact of fiscal stimulus on GDP to be within 0.3 and 0.9 percentage points (pp) of extra growth in 2011. For 2012 this estimate comes up to a range between 2 and 6 tenths. However, not only the new fiscal measures will boost meaningfully the economy. The reduced uncertainty also biases upwards our growth forecast as business confidence keeps improving since the dip during the summer. All in all, we have revised upwards our growth forecast for 2011 by 0.7 pp to 3% with risks tilted to the upside as confidence effects could turn out to be stronger than anticipated.

Chart 5
USA: labour and consumption indicators



Source: BBVA Research based on Datastream and Bloomberg

Chart 6
US Business confidence



Source: Haver Analytics

However, the recovery is still vulnerable, and new risks emerge for the long run

However, weaknesses have not disappeared. Real estate markets remain feeble and still prone to negative surprises. Household income is still sluggish given that the speed of the recovery will not be sufficient to significantly reduce unemployment rates. On top of it, credit growth and securitization processes remain subdued. While none of this should derail the recovery, it continues to configure a scenario in which an additional negative shock would harm the economy. For now, this outlook of gradual economic recovery with low inflationary pressures on the demand side will permit monetary policy to remain accommodative for an extended period. At the same time, even if chances of a double dip scenario in the US have faded, a new risk could be emerging from higher long-term interest rates after the US government decided to postpone, once again, fiscal consolidation. Even if fiscal stimuli boosts activity in the short-run, a sudden and sharp increase in long-term interest rates becomes a risk in the long-run (see box 1).

The pick up in economic activity and increasing commodity prices have also reduced significantly deflation concerns. In fact, there has been a change in sentiment towards inflation worries, particularly after uncertainty surrounding the commodities market (see section 4). However, core inflation has not been significantly affected and, in fact it remains well below the Fed's implicit target. As a consequence, the Fed has hardly responded to last quarter's movements in inflation and it does not seem likely to do so in the near future. We thus keep unaltered our outlook for official rates in the US, which will continue at current levels for a protracted period, while employment remains subdued. This sharply contrasts with the change in the ECB rhetoric (see section 3).

BOX 1: Why is market pressure for US consolidation lower than in Europe?

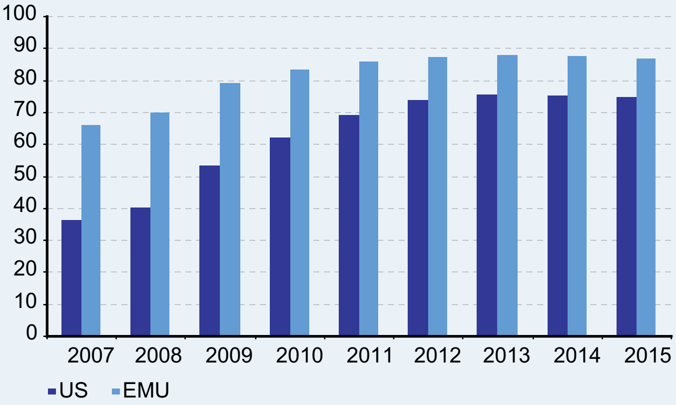
Since 2009 markets had been pushing the European peripheral countries to accelerate the pace of the fiscal consolidation amid concerns about debt sustainability. The situation became critical at the beginning of 2010 with the bail–out of Greece which encouraged all Eurozone countries (and the UK) to implement new measures or bring forward existing ones to ensure that fiscal deficits would meet a rough target of 3% by 2013. At the end of 2010 the debt crisis intensified and extended to other peripheral countries, but all European governments have been under market pressure to provide signs of strengthening public accounts.

Until mid-2010 it was widely thought that there was not much fiscal space left in the US. It had taken important counter-cyclical measures in 2008 and 2009 to boost the economy in the aftermath of the financial meltdown. Those measures led the US to reach debt and deficit levels not seen in peacetime. In 2009 the US posted a public deficit of 10% of GDP (6.3% in the Eurozone) and a debt of 53.5% of GDP, 17.3 pp above 2007's figure. In fact, the debt level expected to be reached in the US by 2015 is not meaningfully different from the European, and deficits were expected to be even higher than in Europe (at around 4% by 2020). Under those circumstances, the US was widely expected to shift shortly towards a more tight fiscal policy, even if the pace was not likely to be as intense as in the Eurozone.

However, at the beginning of December the US government decided not to end the fiscal stimulus but, in a surprising movement, extended it and implemented new tax cuts. The new stimuli accounts for 800 billion dollars (5% of GDP) which will boost the economy in the short run. As can be seen in charts 7 and 8, the expected evolution of public finances in the US and the EMU is quite similar, though markets are not reacting in the same way. Since November yields have increased by 70 bps (Chart 9) but some of this increase is also a consequence of good macroeconomic data. In fact, the spike in rates after the new measures were announced just offsets the previous fall that followed the announcement of QE2.

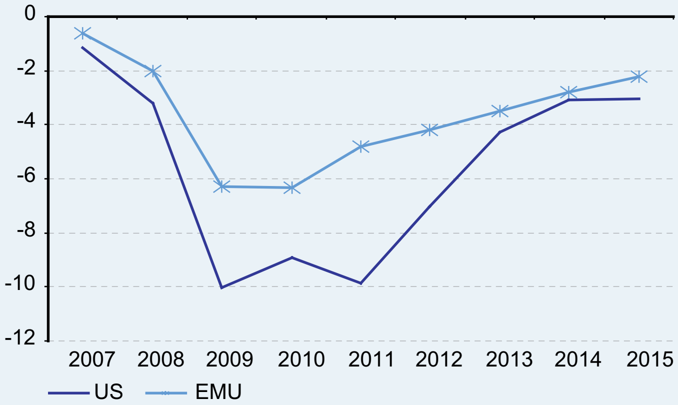
However, some studies for the US (see chart 10) show that, historically, yields go up when deficits and debts increase. In particular, an increase in public debt by 1% of GDP is usually associated with an increase in long-term rates of between 3 and 5 basis points (bps). Given that public debt in the US is projected to increase by 42% of GDP from 2007 to 2015 that would mean an increase in long-term rates on a range between 125 and 210 bps from their levels in 2007. But 10 year bond yields have actually decreased by 180 basis points in the same period. Thus the potential for an upward correction of long-term rates is between 300 and 400 bps. Alternatively, if we focus on the evolution of deficits, the same studies show that a permanent increase in deficits by 1% of GDP tends to increase long-term yields by between 18 and 67 bps. Given that public deficits are projected to increase by 3.8% of GDP between 2007 and 2015, that would translate into an increase in 10-year yields of between 70 and 250 bps, to be added to the 180 bps reduction in long term rates up until January 2011.

Chart 7
Public debt (% GDP)



Source: BBVA Research, Eurostat and CBO

Chart 8
Public deficit (% GDP)

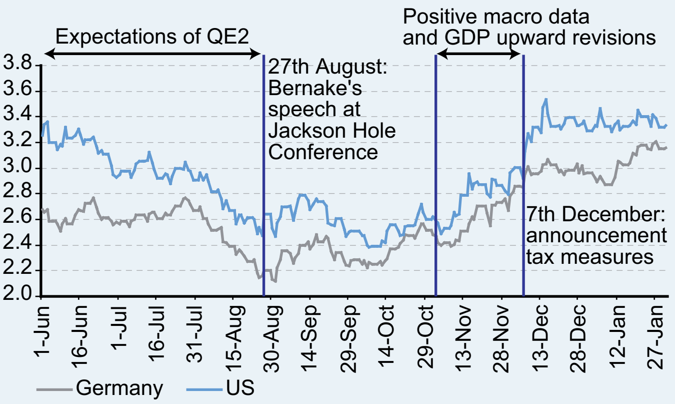


Source: BBVA Research, Eurostat and CBO

Why is market pressure for US consolidation currently lower than in the past and lower than in Europe? There are several structural factors that are contributing to sovereign debt stress tilted against EMU. First, the banking crisis has been successfully addressed in the US whereas is still pending in Europe, with some pockets of extreme risk. Second, the debt levels and debt burden in the US is quite manageable and, even if it is also in Europe as an aggregate, some doubts about sustainability remain in some EU countries. A third set of factors is related to economic resilience: whereas in the US the economy has recovered and GDP levels are not far behind those in the pre-crisis period, the recovery in the EMU is still mild. And what it is even more important, potential GDP growth is higher in the US (a more flexible economy) than in Europe, with stagnation and diminished competitiveness. Finally, political and institutional factors could be pointed out, as the US has strong and unified institutions whereas the UE shows governance problems. In addition, other short-run factors put downward pressure on US rates, although looking forward, those factors are uncertain. Those elements could be flight to safety in periods of financial stress, purchases of debt (and Agencies) by the Fed and the continued investment in US assets for foreign reserve accumulation.

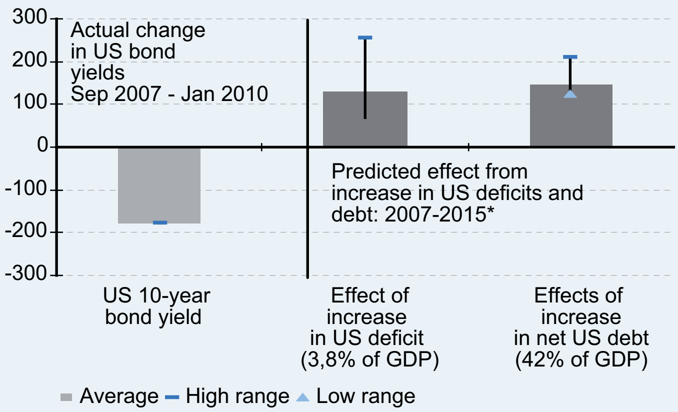
However, the lessons from the sovereign crisis in Europe should not be forgotten. One should not overestimate the strength and persistence of the factors that have prevented a negative reaction from bond markets to a further delay of fiscal consolidation in the US. Central bank bond purchases and the turmoil in Europe (and thus flight to quality to US bonds) are by nature short-run factors that will disappear in the medium run, and before that happens the US will need to show a clear commitment to fiscal consolidation or risk a sudden spike in long-term interest rates. Rating agencies have already started to signal this risk. There is time, but discussions and plans should start as soon as possible to reduce long term fiscal concerns.

Chart 9
10 year government bond yields



Source: BBVA Research and Bloomberg

Chart 10
Actual and predicted changes in US bond yields



* Based on Gale and Orzag (2004), Laubach (2009), Engen and Hubbard (2004) and Thomas and Wu (2009)
Source: BBVA Research

3. Financial tensions in Europe: a window of opportunity

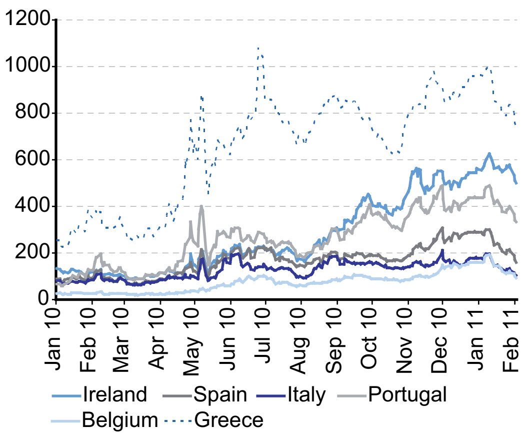
Doubts about the true health of the financial sector and the ability of European institutions to solve sovereign debt crises led to renewed pressures in funding markets at the end of 2010, but a window of opportunity seems to have opened up in late January

Since the end of October, financial tensions in Europe have surged again, especially in peripheral countries (Chart 11). However, as opposed to the stress episode in May, financial spillovers to other countries or regions were more limited, as global risk aversion did not seem to increase markedly, as seen, for example, in the evolution of the VIX (Chart 12). The increase in tensions was started by two events that increased concerns about the health of the financial sector and doubts about the EU's ability to solve its sovereign debt crisis. These two factors surged against the background of ongoing concerns about the capacity of some peripheral countries like Portugal and Ireland to fulfill their fiscal consolidation targets and doubts about the ability of some European economies to generate enough growth momentum to make their debt burden sustainable.

The first trigger was the European summit of 28 October, after which market participants increased their doubts about the ability of European authorities to deal with sovereign debt crisis. Prior to the summit, the reform of the Stability and Growth Pact (SGP) had been designed and debated by the European Commission (EC), with input from the ECB and member states. It envisioned sanctions for countries that would not fulfill fiscal targets, some control of fiscal budgets by the EC and monitoring of macroeconomic imbalances, to address competitiveness problems at an early stage. However, pressed by France (after the Franco-German agreement), the European Commission introduced a voting mechanism whereby sanctions would not be fully automatic, raising the specter of a toothless SGP. At the same time, and more importantly, Germany tried to push the resolution of the debt crisis onto the markets, by proposing a private-sector participation in any debt crisis resolution starting in 2013. Private investors were thus spooked by the prospect that they would bear losses on possible restructurings even before 2013, since the suspected insolvency of some European countries made it likely that haircuts on new debt issued after 2013 would not be enough to restore fiscal sustainability. After all, the reinforcement of fiscal discipline had been in the end watered down by the possibility of lifting sanctions for countries breaching the SGP.

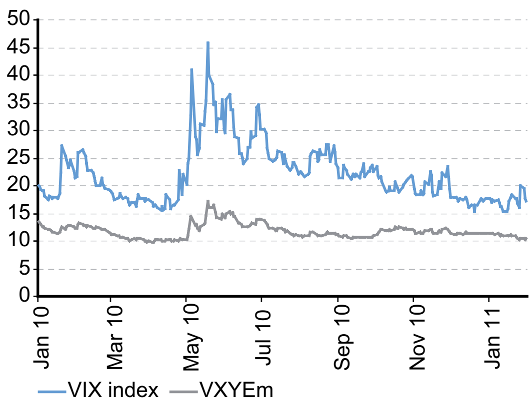
The second trigger was increasing doubts about the true health of the financial sector in Europe, since Irish banks had to be recapitalized shortly after they passed the European stress tests. These doubts spread even to countries like Spain, where stress tests included all institutions, with more severe scenarios and realistic assumptions. After massive injections of capital into some Irish banks, reduced quality of assets left in the banking system, increased reliance on the ECB for funding and increased penalties for the use of Irish assets in international repo transactions the Irish government was forced to seek assistance from the EFSF. But doubts now turned into other peripheral countries like Portugal, Spain, and even Italy and Belgium at the end of 2010.

Chart 11
Sovereign CDS spreads (5yr) in European peripheral countries*



* Spread to Germany
Source: BBVA Research and Datastream

Chart 12
Implied Volatilities (VIX* and VXYEm)**



*VIX: Implied volatility in S&P 500 equities.
**VXYEm: Implied volatility in emerging market exchange rates
Source: BBVA Research, Bloomberg and JPMorgan

These renewed tensions highlight the urgent need for comprehensive crisis prevention and resolution mechanisms that reduce uncertainty and thus market volatility

These renewed tensions, after what seemed a period of differentiation and relief after the summer, highlight that markets are increasingly focusing on solvency problems in some European countries and not just liquidity concerns. At the same time, markets increasingly need assurance that European institutions will be capable to prevent a similar episode in the future and, if not, that a transparent and predictable mechanism of crisis resolution is in place. After new governance proposals have been voiced by different European authorities and some negotiating positions seem to have softened, markets seem to have calmed down somewhat, opening up a window of opportunity to solve this crisis.

The solution for this crisis has to address both liquidity and solvency concerns, depending on the country. For liquidity problems, the EFSF needs to be improved, both quantitatively and qualitatively. In the first case, its lending limit needs to be expanded to a level sufficiently high to (i) be very difficult for markets to test, and (ii) avoid several rounds of political negotiations each time the ceiling has to be raised. Qualitatively, the EFSF should be revamped so that it can lend at lower rates –not to convert a liquidity problem into a solvency one–. The current debate on what to include in the reform package to be delivered by the end of March by the European Council suggests that some of this measues will be finally approved. But increasingly this crisis is about what to do with countries that are suspected as fiscally insolvent. In this respect, the EC should determine which countries are in this predicament, and their debt should be reduced to levels deemed as sustainable through appropriate EU policies (including, for example, the use of the EFSF to buy back debt at market prices) and with very strong conditionality. However, at this stage it is as crucial to also guarantee an adequate transition mechanism that does not scare financial markets as it did at the end of 2010.

What to do for the long run, to be ready for possible next crises? A strong framework for crisis prevention and resolution needs to be put in place. For crisis prevention, it is essential to equip the existing monetary union with a framework where (i) fiscal policies are more coordinated and serve as shock absorbers for idiosyncratic shocks, and (ii) the build up of private imbalances is also monitored and prevented. Thus four elements are important: (i) the new SGP needs to widen its criteria for assessing macroeconomic imbalances (not just fiscal, but also external); (ii) the possibility of fiscal transfers is increased, to serve as shock absorbers; (iii) Eurobonds cover up to a sizable percentage of national debt (but still leaving part to be issued separately, to keep market discipline), and, crucially (iv) deviating countries should be automatically sanctioned. This will increase much needed credibility in the system. Though the first of these points has been incorporated, the later three are under debate and are not accepted by all countries, as they imply a further fiscal union or higher powers for the EU.

But of course, not all crises can be prevented, so a robust framework for the resolution of solvency crises also needs to be put in place and be as clear and transparent as possible (liquidity crises should be managed by a permanent version of the EFSF). To keep market discipline, the private sector needs to participate in any debt restructuring in future crises, with rules well known in advance, for example, by the use of collective-action clauses on sovereign debt (CACs).

Spillovers from financial tensions to economic activity have been limited so far, even in peripheral Europe, but this decoupling will not last if EU governance and economic reform is not implemented shortly

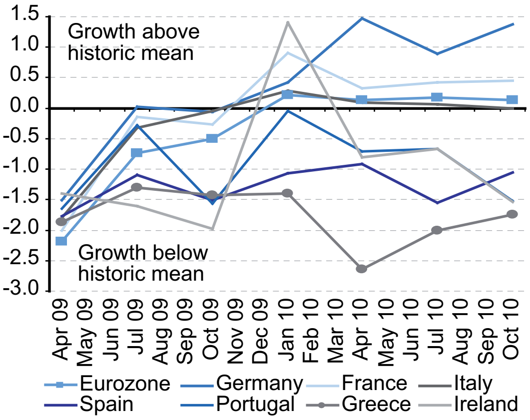
Until now, financial tensions have affected access to financing by the corporate sector, especially in peripheral economies, but have not been fully transmitted into the real side in peripheral economies, and much less into core countries in Europe. Indeed, economic activity has remained more or less stable in peripheral Europe, and has surprised to the upside in Germany and other countries in central Europe, mostly due to strong foreign demand, increasing disparities in the rates of recovery in both areas (Chart 13). However, the risk is that continuing weakness of financial institutions in many EU countries and lack of transparency about their exposures might end up spreading financial turmoil from the periphery to core Europe. Although the periphery accounts for a small proportion of total EU economic activity, financial linkages with core countries, as well as spillovers through increased risk aversion and lower equity prices could generate a slowdown in demand that will reduce growth in Europe even further below the US. Thus, the decoupling between core and peripheral Europe and between financial and real sectors in Europe will not last if EU economic governance is not reformed comprehensively and economic reforms are pushed in key areas like labor and product markets and the financial system. In this respect, the outcome of the next European Council in March will be crucial, as well as the results of new stress tests to the European financial system, to be conducted and published during the first semester of this year.

In the meantime, inflation risks increase, prompting a more hawkish rhetoric by the ECB than the Fed

As presented in detail in the next section, commodity prices have started to push up inflation readings globally. In particular, the EMU has seen an increase in headline inflation above the ECB target of 2% since November, including –importantly– in countries in central Europe. Thus, the ECB decided to accommodate its wording to a context of higher inflation risks but setting a tone that was more hawkish than expected. At the same time, its assessment on growth has been more positive, in line with our improved forecast for growth in the eurozone in 2011 and 2012. Nevertheless, core inflation remains well under 2% and the recovery of domestic demand remains hesitant, and thus significant second round effects on inflation domestic demand are unlikely. We still think that the ECB will keep official interest rates unchanged at least during this year (Chart 14), and in any case monetary policy will remain accommodative for a long time.

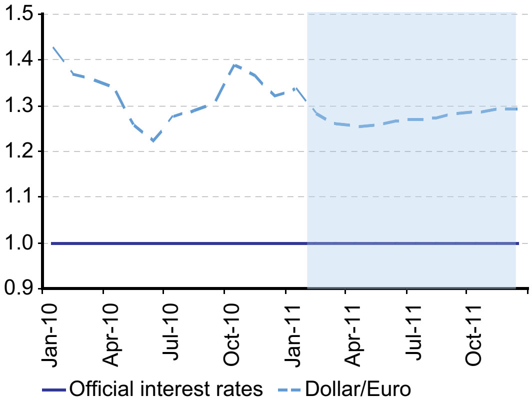
The relatively more hawkish approach by the ECB to possible inflation risks (as compared to the Fed) together with a slight reduction in financial risk prompted by the sense of more action on the part of European authorities induced an appreciation of the euro vis-à-vis the dollar at the end of January (Chart 14). Going forward, and once these two factors are out of the picture (together with the end of QE2) we should go back to more fundamental factors driving euro-dollar exchange rates. They 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.

Chart 13
BBVA synthetic index of economic activity for EMU countries



Source: BBVA Research and Datastream

Chart 14
EMU: official interest rates and dollar-euro exchange rate



Source: BBVA Research and Datastream

4. Commodity prices will level off

Commodity prices surged recently as a result of strong investment flows and transitory supply-side factors, in a context of a persistent demand pressure from emerging economies

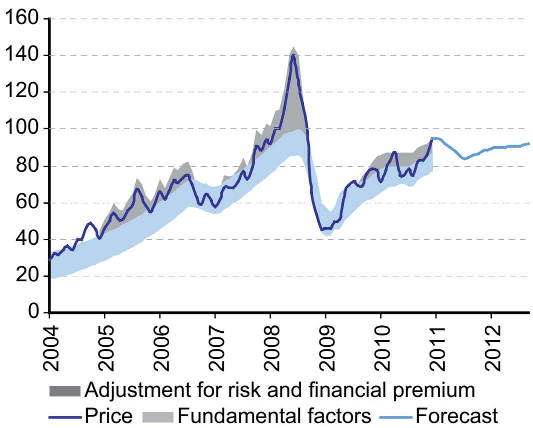
Commodity prices have risen sharply in recent months. Oil prices rose 20% in the last 6 months, whereas food and metal prices increased by almost 30% in the same period (see Chart 4). The surge in soft commodities (food) prices broke the weak trend exhibited since the post-crisis period. In the case of metals, this rally continues with the trend observed since 2009, exceeding pre-crisis levels and in some cases achieving all-time highs, such as in the case of copper. Oil prices have also recently accelerated following a stable behavior in the first half of 2010.

These price increases are the result of some supply-side problems in certain commodities (weather disturbances and natural disasters in some regions, and political instability in areas close to major oil producing nations), in a context of persistently strong demand from emerging economies. However, the recent sharp price increases have been driven mainly by strong investment flows into commodities and also in part due to the depreciation of the US dollar.

Given ample global liquidity conditions, low interest rates prevailing in developed economies, and increased risk in European assets, investors' search for yield is pushing them increasingly to commodity markets as a profitable asset class, thus increasing financial premia across the board, as seen in Charts 15 and 16 for the case of oil and soybeans. The weakness of the US dollar after the implementation of QE2 is another factor which accounts for the short-term increase of commodity prices quoted in that currency (Chart 17).

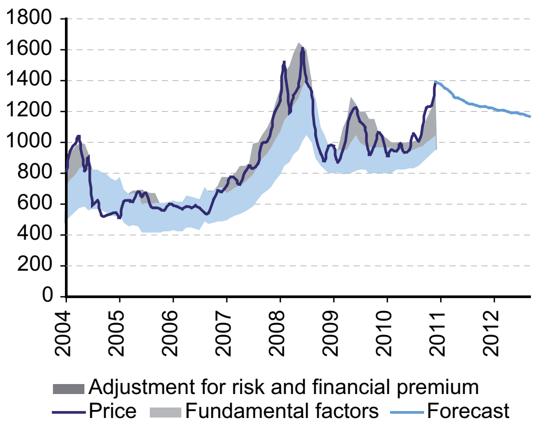
Beyond these short-run factors, there exist pervasive forces driving up commodity prices across the board. A new cycle of high prices seems to have started at the outset of the present decade, fueled by fast Asian economic development. Rising incomes, urbanization and fast industrialization in China and more recently India are putting a lot of pressure on almost all commodity market.

Chart 15
Oil price (Brent, USD per barrel)



Source: Datastream, Bloomberg and BBVA Research

Chart 16
Soybean price (USD cents per bushel)



Source: Datastream, Bloomberg and BBVA Research

Going forward, commodity prices will stabilize as some short-run upward pressures fade away. However, risks are tilted to the upside

Going forward, although the projected weakening of the dollar will contribute to support commodity prices, we expect them to level off around current readings, as a result of the correction of the main short-run factors that pushed prices up, namely supply shocks and investment flows into commodity markets.

In fact, the current dynamics of climbing prices do not fully reflect the situation in physical markets. Upward pressures on food prices will ease as crops normalize in 2011. In the case of metals, the tight market conditions are not sustainable on account of the heightened existing inventory levels. As for oil, even though in our view markets overreacted in the last months, the tight situation in the physical market should prevail, pushing prices slightly higher in 2011 but gradually easing afterwards.

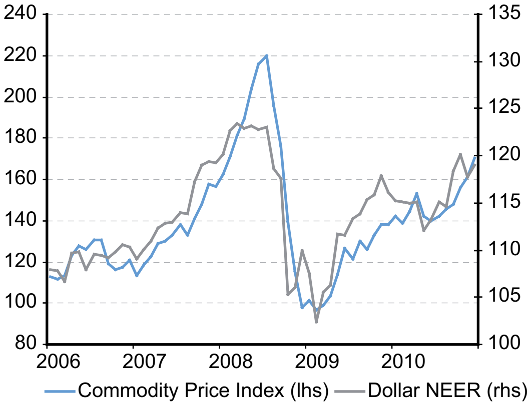
This easing will be helped by a likely reduction in financial tensions in Europe, which should shift investment flows away from commodities into other assets with more contained risk premia. As a result of the crisis, risk premia in Europe rose and risk-adjusted profitability dropped, inducing investors to shift their portfolios to higher-return assets, such as commodities, which only underwent a slight global contagion. In the medium term the steady reduction in financial stress in Europe will move part of investment flows again towards other assets.

However, risks are tilted to the upside, with a renewed commodity price rally, in case that Chinese authorities are not able to contain domestic demand, European financial distress does not abate – or geopolitical tensions escalate, in the case of oil prices –. This situation would worsen overheating pressures in some emerging economies and global inflation dynamics.

From a long-run perspective, the strong demand in Asia will continue to support an upward movement in relative prices, breaking their well-known historical downward trend (Chart 18). However, this trend could be counterbalanced by a larger supply originated by firms' investments in production capacity to benefit from higher prices in the market. In the case of metals, we have seen how high prices have resulted in a notable increase in investment. These investments may take several years to bear fruit, but with higher prices, there should be plenty of incentive to find new sources of raw materials.

Chart 17

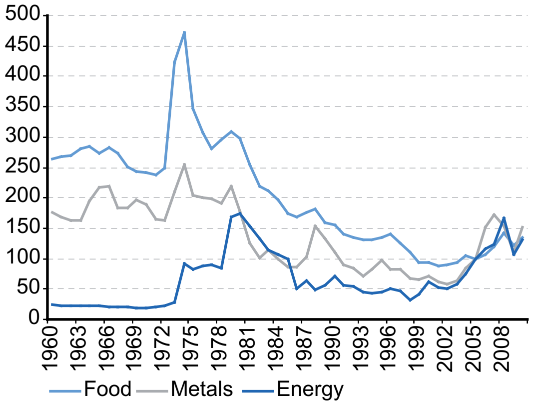
Commodity price index and USD nominal effective exchange rate



Source: BBVA Research and Datastream and IMF

Chart 18

Commodity prices in real terms* (2005=100)



* Adjusted for US inflation
Source: BBVA Research and IMF

5. Emerging economies: risks of overheating

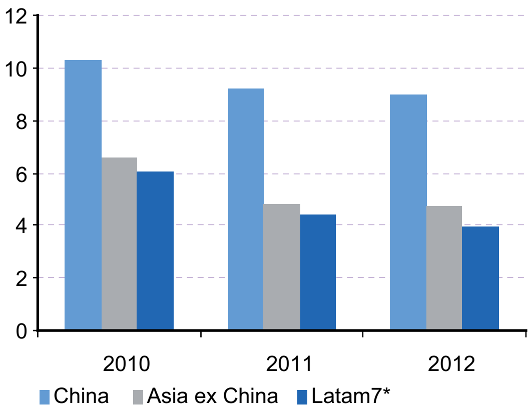
Emerging economies continue growing strongly and risks of overheating come to the fore

Emerging economies in Asia and Latin America, continue growing strongly (chart 19), leading the global recovery and the decoupling from advanced economies (see also Box 2). In both regions domestic demand remains strong and is the main driver of growth, as policies remain highly accommodative (even as fiscal stimulus is withdrawn, except in China), the inventory cycle ends and external demand weakens – except for Latin America, where high commodity prices are also supporting the dynamism of economic activity –. Although GDP outturns at the end of 2010 were higher than expected (thus raising our estimate of 2010 growth) in our opinion GDP growth in 2011 and 2012 should not deviate significantly from our previous forecasts, except in the case of Mexico.

We still envision strong growth in China on its way for a soft landing, given the authorities' determination to slow rapid lending growth, tame inflation, and cool down the property sector. Measures are likely to include further exchange rate appreciation and targeted measures to slow the property market, such as implementation of a property tax on a pilot basis in a few large cities. For the rest of emerging Asia, growth will also be strong going forward, slightly above 4%. Nevertheless, risks are tilted toward overheating, as China's already strong growth momentum has turned out to be even higher than previously expected, loan growth targets in 2010 were exceeded and inflation has risen well above the authorities' targets (see Chart 2). For the region as a whole, inflation and asset price bubbles are likely to remain a concern next year, fueled by capital inflows and low interest rates.

Latin America has been growing faster than expected at the end of 2010 due to strong domestic demand growth, improved terms of trade and strong capital inflows. Nevertheless, we expect GDP growth to continue converging to potential growth of about 4% for the region as a whole. Investment growth is playing a major role in the expansion of domestic demand and fiscal and current account balances will continue benefiting from high commodity prices. The outlook has improved substantially in Mexico, highly influenced by the improved growth outlook in the US for 2011 and 2012. As opposed to Asia, inflation in the region for now remains moderate, but rising food and energy prices could cause some temporary increase going forward. In any case, risks in South America are also tilted to slight overheating, especially in some countries like Brazil, where the current account keeps deteriorating rapidly even in the context of positive terms of trade.

Chart 19
Emerging economies GDP growth



* Arg, Bra, Chi, Col, Mex, Per, Ven
Source: BBVA Research

Chart 20
Risks from first round effect of an additional increase in food prices

Low Risk	Medium Risk	High Risk
Chile	Mexico Colombia	Brazil Peru
S. Korea	China Philippines Indonesia	India Turkey Vietnam

Source: BBVA Research

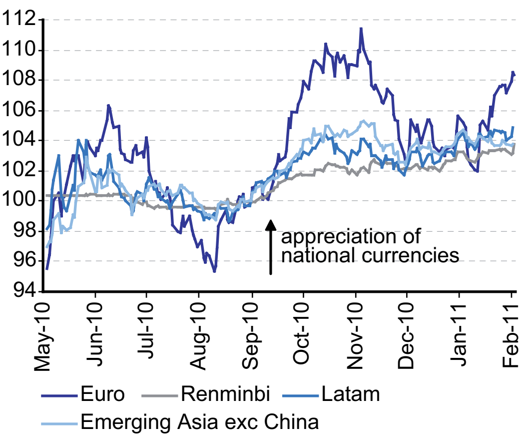
Inflation risks start being a concern in emerging regions, fuelled by commodity prices, but also domestic demand pressures.

Inflation risks start representing a major risk for emerging economies. As discussed in the previous section, we forecast stable commodity prices around current levels, but with risks tilted to the upside. Especially important are risks derived from an increase in energy and food prices, the latter because of a bigger weight of foodstuffs on CPI indexes in emerging economies as compared with industrialized countries. In this respect, some countries are especially at risk, either because inflation rates already start from a high level (Brazil, India or Vietnam, for example) or because inflation is highly sensitive to an increase in food prices, given their bigger weight on the consumption basket (Peru, Philippines and Vietnam, to name a few). Chart 20 classifies countries in Latin America and Asia according to the first round effect of an increase in food prices, showing that inflation risks are highly heterogeneous within regions. This heterogeneity also extends to the comparison between regions: Asia presents bigger inflation risks both on account of higher starting inflation rates and higher sensitivity to food prices than Latin America.

Notwithstanding this, additional inflation risks also stem from domestic demand pressures in part fuelled by capital inflows: rapid growth in emerging economies is narrowing (in some cases even closing) output gaps fast and thus overheating pressures are surfacing. These pressures were to some extent contained in the last months of last year, as increased financial woes in Europe seemed to moderate capital inflows to emerging economies while uncertainty was still high. This moderation of inflows was also partly reflected as well in reduced appreciating pressures between October and year's end (Charts 21 and 22) and some central banks suspending their monetary policy tightening. Going forward, the reduction in Europe's financial stress is likely to restart capital inflows.

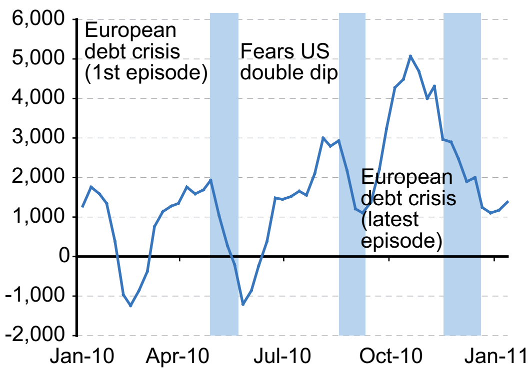
Going forward, given an expected easing of financial stress in Europe, capital inflows to emerging economies will resume, providing further fuel for increases in asset prices and domestic demand pressures. Thus, policy dilemmas already present last year will intensify, challenging policymakers with the tradeoff between cooling inflation and domestic demand and allowing further appreciation of their currencies. We expect most central banks resuming their paths of monetary tightening (including credit tightening measures in some countries), as inflation risks mount. At the same time, they will lean heavily against further exchange rate appreciation with strong interventions and some capital controls, although they are not likely to prevent completely the appreciation of their currencies as experience shows that their effectiveness is rather limited.

Chart 21
Bilateral exchange rates to the US dollar



Source: BBVA Research

Chart 22
Equity capital flows to emerging economies



Source: BBVA Research and IMF

BOX 2. EAGLEs: the key emerging markets in the next 10 years

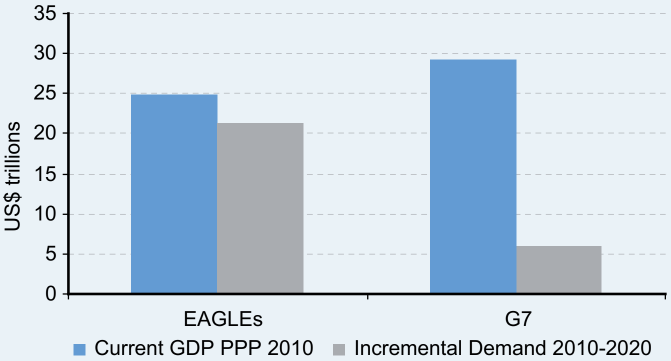
The decoupling between the growth rates of emerging markets and the developed countries is not, in our view, a cyclical phenomenon. On the contrary, it is a structural feature of the global economy in the medium term. There are several factors behind this view. First, the impact of the crisis and the tolls imposed by its resolution are clearly much larger in the developed markets, where we expect a significant slowdown from the pre-crisis expansionary period. For emerging markets, the drag created by the crisis is much less severe and the quick recovery observed in 2010 is proof in our view of this. Looking over the longer term, BBVA Research has conducted detailed estimates of potential GDP growth based on forecasts for the likely growth rates of production factors (employment, capital and TFP). This comprehensive exercise highlights how the Emerging Markets, as a whole, can rely on a stronger basis for long term growth than the developed economies. In particular, their demographic prospects are better, implying that conservative forecasts over the long term do not require an acceleration in investment or total factor productivity.

In view of this, it is understandable that investors have shown greater interest in finding new ways to position for this rotation in world growth towards the Emerging Markets. BBVA Research has created an ongoing project to provide information about this issue. This effort is focused around the EAGLEs concept. EAGLEs stands for "Emerging and Growth-Leading Economies" and it is the group of emerging markets whose contribution to global growth over the next 10 years is expected to be higher than for the large industrial countries (which we define as the G6, ie. the G7 excluding the US). Our approach has several advantages versus alternative acronyms recently launched:

- Instead of looking at economic size and population, which may be misleading, EAGLEs focuses on the incremental GDP (IGDP) economies will generate instead, that is, their contribution to world growth. The use of IGDP is key: having a big size or a high growth rate is not enough on its own to be a key global player; it is the combination of both that really matters. This is a more relevant concept for identifying business and market opportunities with more anticipation (chart 23 and 24).
- Dynamic: it is updated each year on the basis of economic performance and changes in economic conditions, as reflected in BBVA Research forecasts. It is not a closed group and the concept is not linked to an acronym formed by a given set of countries. This will allow identifying key markets in the EM universe and warn about potential "fallen angels" in advance.
- Objective: the criterion for inclusion is explicit. In order to become an EAGLE each country's expected incremental GDP in the next 10 years needs to be greater than the one anticipated for the average of the G7 economies, excluding the US.
- The results are based on a shorter horizon - 10 years - than the ones considered in other cases, ranging from 20 to 50 years, as global economy may experience huge changes in such a long period of time. This horizon is more relevant for most investment decisions.

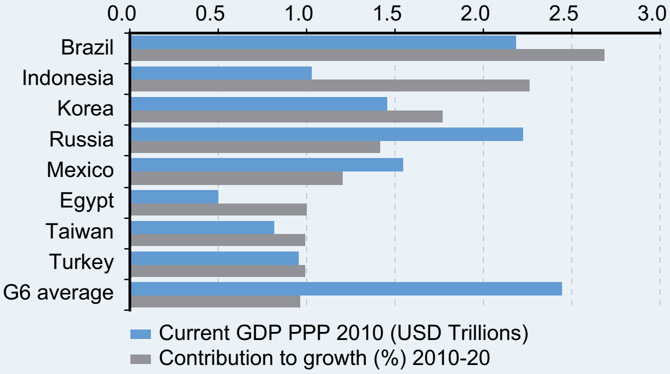
Who are the EAGLEs? Some surprising results are highlighted by our methodology. According to BBVA Research forecasts, world GDP in the current decade will increase by 41 trillion US dollars adjusted by PPP. The EAGLEs contribution (their IGDP) will be slightly over 50% whereas G7 share will only be 14%. It is worth highlighting China's expected role in the next ten years; its contribution to total world growth will account for almost 30% of world growth, four times more than the US and 2.4 times more than the other three BRIC countries. India will actually match the US contribution to growth, even if it GDP will still be lower by 2020. Brazil will be the third biggest contributor, followed by Indonesia and Korea (chart 24). Note that Indonesia and Korea will each contribute to world growth more than Russia, and if combined these two economies will generate 1.5 times more incremental GDP than Brazil. This is a clear case where the relevance of the BRIC concept is challenged. Next on the list is Mexico, whose IGDP contribution is expected to be greater than the one of Germany or the UK, in spite its current GDP size adjusted by PPP is only 53% and 71% of them respectively. Finally it is Egypt, Turkey and Taiwan; each economy's IGDP is expected to be higher than in Canada, France and Italy. The non-EAGLE Brics will be more relevant for world growth than the G6 or other similar concepts, while using a reduced number of countries. In summary, the EAGLEs group is the group of emerging markets that are already relevant and are expected to gain even more prominence in this decade.

Chart 23
Developing vs Developed Economies (USD PPP Trillions)



Source: BBVA Research

Chart 24
Other major EM apart from China & India (% share, USD Trillions)



Source: BBVA Research

6. Tables

Table 1

Macroeconomic Forecasts: Gross Domestic Product

(YoY growth rate)	2008	2009	2010e	2011f	2012f
United States	0.4	-2.6	2.8	3.0	2.7
EMU	0.3	-4.0	1.7	1.7	1.8
Germany	0.7	-4.7	3.6	2.4	1.9
France	0.1	-2.5	1.5	1.6	1.8
Italy	-1.3	-5.1	1.1	1.0	1.1
UK	-0.1	-4.9	1.4	1.7	1.9
Latin America *	4.0	-2.4	6.0	4.4	3.9
EAGLES **	6.6	3.5	8.3	7.0	6.8
Turkey	0.7	-4.7	7.6	4.5	4.5
Asia Pacific	5.6	3.7	8.1	6.5	6.4
China	9.6	9.2	10.3	9.2	9.0
Asia (exc. China)	2.9	0.1	6.7	4.8	4.7
World	3.0	-0.6	4.8	4.4	4.4

Forecast closing date: January 31, 2011
* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
** Brazil, China, Egypt, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Source: BBVA Research

Table 2

Macroeconomic Forecasts: Inflation (Avg.)

(YoY growth rate)	2008	2009	2010e	2011f	2012f
United States	3.8	-0.3	1.6	1.3	1.5
EMU	3.3	0.3	1.6	1.8	1.6
Germany	2.8	0.2	1.2	1.8	1.4
France	3.2	0.1	1.7	1.7	1.6
Italy	3.5	0.8	1.6	1.7	1.8
UK	3.6	2.2	3.3	3.3	2.1
Latin America *	7.7	7.0	7.7	8.0	8.1
EAGLES **	7.4	2.8	5.2	5.2	4.8
Turkey	10.4	6.3	8.6	6.6	6.1
Asia Pacific	5.7	0.3	3.5	3.8	3.5
China	5.9	-0.7	3.3	4.5	4.0
Asia (exc. China)	5.5.	1.0	3.7	3.3	3.2
World	6.1	2.2	3.6	3.7	3.5

Forecast closing date: January 31, 2011
* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
** Brazil, China, Egypt, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Source: BBVA Research

Table 3

Macroeconomic Forecasts: Current Account (% GDP)

	2008	2009	2010e	2011f	2012f
United States	-4.7	-2.7	-3.4	-3.5	-3.4
EMU	-0.9	-0.6	-0.5	0.0	0.1
Latin America *	-0.3	-1.8	-1.0	-1.1	-1.4
EAGLES **	3.9	2.4	2.1	1.9	1.6
Turkey	-5.6	-2.2	-5.9	-5.7	-4.9
Asia Pacific	4.8	3.8	3.0	3.3	3.2
China	9.9	6.1	4.6	5.1	5.0
Asia (exc. China)	1.4	2.3	2.0	2.2	2.0

Forecast closing date: January 31, 2011
* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
** Brazil, China, Egypt, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Source: BBVA Research

Table 4

Macroeconomic Forecasts: Government Deficit (% GDP)

	2008	2009	2010e	2011f	2012f
United States	-3.2	-10.0	-10.2	-10.1	-6.8
EMU	-2.0	-6.3	-6.2	-4.4	-3.7
Germany	0.0	-3.3	-3.6	-2.5	-2.2
France	-3.3	-7.5	-7.5	-6.0	-5.3
Italy	-2.7	-5.3	-4.5	-3.6	-2.8
UK	-4.9	-11.5	-10.7	-8.8	-6.6
Latin America *	-0.9	-6.0	-1.5	-1.5	-1.1
EAGLES **	-1.8	-5.5	-3.7	-3.1	-2.5
Turkey	-1.8	-5.5	-3.6	-3.3	-3.3
Asia Pacific	-2.8	-5.1	-4.8	-4.2	-3.5
China	-0.4	-2.8	-2.8	-2.3	-2.1
Asia (exc. China)	-4.4	-6.5	-6.1	-5.4	-4.5

Forecast closing date: January 31, 2011
* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
** Brazil, China, Egypt, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Source: BBVA Research

Table 5

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

	2008	2009	2010	2011f	2012f
United States	3.6	3.2	3.2	3.4	3.8
EMU	4.0	3.3	2.8	3.1	3.1

Forecast closing date: January 31, 2011
Source: BBVA Research

Table 6

Macroeconomic Forecasts: Exchange Rates (Avg.)

US Dollar per national currency	2008	2009	2010	2011f	2012f
United States (EUR per USD)	0.68	0.72	0.76	0.79	0.78
EMU	1.47	1.39	1.33	1.27	1.29
UK	1.82	1.56	1.55	1.53	1.52
China	6.95	6.83	6.77	6.46	6.10

Forecast closing date: January 31, 2011
Source: BBVA Research

Table 7

Macroeconomic Forecasts: Official Interest Rates (End period)

	2008	2009	2010	2011f	2012f
United States	0.61	0.25	0.25	0.25	0.50
EMU	2.73	1.00	1.00	1.00	1.00
China	5.31	5.31	5.81	6.56	7.06

Forecast closing date: January 31, 2011
Source: BBVA Research

DISCLAIMER

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