BBVA Research

Global

Economic Outlook

Second Quarter of 2010

Economic Analysis

- The global economy is driven by two conflicting forces: the positive cyclical impulse from emerging countries and the US, and heightened risk premia spreading from Europe. The EMU rescue package reduces uncertainties in the short-run.
- Growing divergence in monetary exit strategies looking ahead: a gradual approach in the US; no clear timing for the exit in the EMU; and no one-size-fits-all strategy across emerging markets.
- Long-run fiscal consolidation is the major challenge for developed countries.
- Economies with high public debt and limited private deleveraging are highly vulnerable to an upward movement in interest rates.

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Closing date: 14th May 2010

1. Challenges ahead for a sustained recovery

The global economy is driven by two conflicting forces: the positive cyclical impulse from emerging countries and the US, and heightened risk premia spreading from Europe. While the EMU rescue package reduces uncertainties in the short run, the balance of risks over the medium-term remains tilted to the downside

The cyclical situation has improved significantly over the last few quarters, driven by the recovery in emerging market economies and the US. Global trade is growing at 7%, and we forecast a 4.2% global growth rate for 2010. At the same time, there are doubts about the ability of the European Monetary Union (EMU) within its current decision-making framework to deal with the high level of indebtedness of some of its countries. These doubts have given rise to widening spreads and renewed financial stress. These developments may impinge first on the European economy with possible spillovers into the rest of the world. The timing and the extent of these adverse impacts will crucially hinge on the effectiveness and lasting effects of the announcement of the rescue package agreed upon by the European Council on May 9 and the exceptional measures adopted by the European Central Bank (ECB). While the package has stabilized market conditions in the short run, uncertainties remain in three main areas: i) the implementation of the rescue package in the months to come, ii) the credibility of further fiscal consolidation to be adopted by some European Union (EU) countries, and iii) EMU core countries' medium-term commitment to the package.

Following the short-term impulse from unprecedented fiscal and monetary expansion worldwide, the sustainability of the recovery is not fully guaranteed beyond 2010, mainly in developed countries

While economic recovery at the beginning of 2010 is widespread, its intensity varies a great deal across countries. This is the result of different degrees of easiness in their fiscal and monetary policies. These policies have been particularly instrumental in providing impulse to the cyclical upturn in China and the US. At the same time, emerging economies are benefiting from the strength of their domestic demand. As a result, the recovery looks more sustained in these economies. Conversely, in developed countries, as expansionary policies fade away, doubts about the sustainability of the recovery beyond 2010 are growing.

Growing divergence in monetary exit strategies looking ahead: a gradual approach in the US; no clear timing for the exit in EMU; and no one-size-fits-all strategy across emerging markets

A very gradual path of interest rate hikes by the Fed is forecast. Early rate hikes by the Fed are expected by the beginning of 2011 with rates slightly above 1% at the end of 2011. There are major differences in economic backgrounds in the US and Europe that will lead to different monetary developments in both areas. Although economic growth may prove sluggish in 2010 and beyond, the risk of a major reversion of the current dynamics is rather limited in the US, with incipient inflationary pressures looming. Conversely, in Europe, in addition to a far more fragile financial situation, the upturn looks more uncertain and inflationary pressures are absent. In the case of emerging economies' monetary policies, there is no doubt about the need for a tightening stance. Given their cyclical divergences, exit strategies will vary across countries. In some countries, if the tightening of monetary policy and other measures are not implemented soon, macroeconomic imbalances will build up.

Markets have shown the limits of countercyclical fiscal policies. Economies with high public debt and limited private deleveraging are highly vulnerable to an upward movement in interest rates and higher risk premia

In heightened risk aversion regimes, financial markets exacerbate their forward-lookingness. Financial markets are particularly good at tracking inconsistent macroeconomic policies, which are overlooked at normal times. Despite the huge rescue package in Europe, substantial risk premia should prevail in the market amid uncertainty on the fiscal consolidation path. Increasing contagion has been clear evidence of the fragility of the current scenario. Economic history is fraught with examples of undue contagion from some countries to others in the aftermath of a crisis. In these cases, geographical linkages or cyclical similarities matter more than the differences in fundamentals. In fact, the current episode of contagion is not fully justified either by the direct financial channel triggered by the Greek crisis or by any similarity in fundamentals. Though its justification may be open to discussion, in order to cope with pressures from international investors, there is a compelling need for some countries to enhance credibility.

Long-run fiscal consolidation is the major challenge for developed countries

There are growing concerns about the long-term consequences of the public debt build-up. This will unavoidably give rise to upward pressures on real interest rates and high risk premia for a protracted period. Even if recent contagion gradually fades away, increasing discrimination across countries, depending on the credibility of their fiscal stance, will prevail.

The lack of a decisive restructuring in the banking sector and the coming regulatory process might jeopardize the recovery

Uncertainty stemming from the financial sector is primarily twofold. The sluggish restructuring of the financial industry, particularly in Europe, will lead to a creditless recovery. This is a growing concern since both historical episodes and empirical evidence show the importance of the credit channel in the early stages of the economic upswing. There is also a high degree of uncertainty regarding the ongoing regulatory reform. The most likely outcome is one of a significant increase in capital and liquidity requirements. This could hinder the ability of the banking sector to grant credit in the coming years.

2. Two conflicting forces leading the world economy

On the upside, the world economy benefits from the positive cyclical impulse in the US and in emerging markets. International trade recovers and world GDP is expected to grow close to 4% in 2010

Some uncertainties hanging over the global economy have been cleared, since over recent quarters the cyclical situation has improved significantly. However, the better tone is not widespread. Latest available data suggest broad ongoing economic recovery in all regions at the beginning of 2010. However, its intensity may evidence substantial heterogeneity across geographies (see Chart 1).

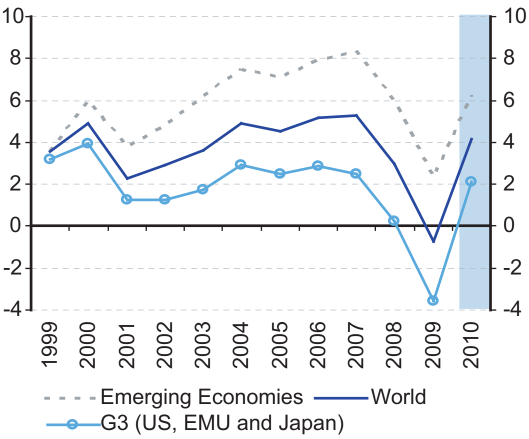
In general, the advanced economies have already accumulated three consecutive quarters of economic growth, but only in the US has it proved to be more intense than expected. Recent evidence entails upside surprises on growth performance of recent quarters, close to a quarterly 1% on average over the last three quarters. Even though the Eurozone has already stopped its decreasing path of growth, activity remains subdued (just 0.1% of the quarterly growth rate on average over the last three quarters), with the latest data clearly confirming our scenario of sluggish recovery lagging behind the US.

This cyclical improvement also engulfs emerging markets. They are boasting substantial dynamism, thereby recovering significant growth rates, already close to those paces observed before the crisis. In fact, in recent months we have been dealing with significant upside surprises in different economies. A case in point is the Chinese economy, with a quarterly growth of 2.7% for the first quarter of 2010, clearly above expectations.

The better tone of emerging countries' domestic demand is not the only factor behind their accelerated growth. The external demand of China has also recovered over the last few quarters (see Chart 2) and a positive contribution is expected in 2010. The remaning Asian countries have benefited from spill-over effects – via international trade and high commodity prices, as shown in Chart 3 – due to stronger Chinese demand and more recently from an external demand that has broadened geographically.

Chart 1

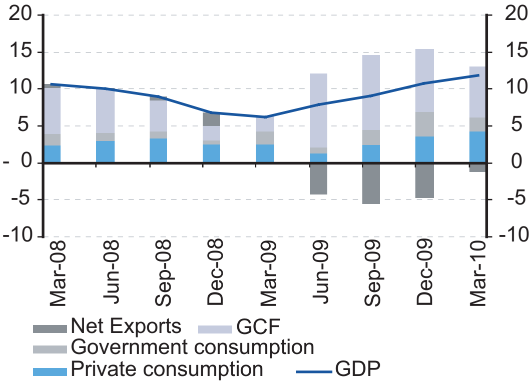
Emerging Economies and G3: GDP Growth (% growth rate)



Source: BBVA Research

Chart 2

China: contribution to GDP growth (% y-o-y)



Source: BBVA Research

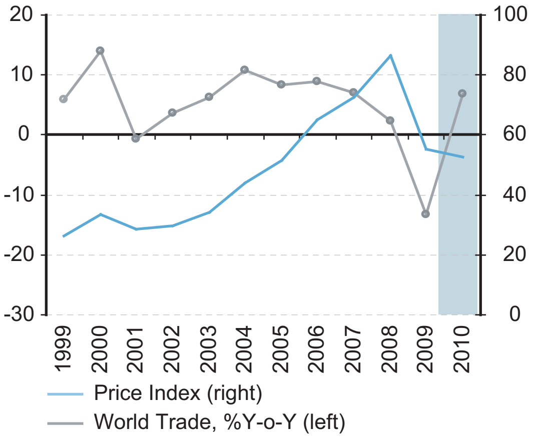
Among the factors behind such cyclical improvement, expansionary fiscal policy has played a key role in supporting activity in many economies and is still promoting growth in some areas. Under such a setting, fiscal policy – through significant macroeconomic stimuli – has succeeded greater than expected by providing more support to activity in the short term in the US and China. In the former, some programs such as the Tax Home Credit and Cash for Clunkers have yielded very positive results. The success stemming from those programs has eventually been larger than expected. Nevertheless, some signs provide evidence that US private demand is recovering apart from public stimulus. Private consumption is thus gaining traction progressively (in the first quarter, consumer spending rose 0.9% q-o-q and contributed 0.6 pp, an improvement from 0.3 pp in the previous quarter) and the labor market is starting to show the first symptoms of a sustainable recovery with the jobless rate already reaching a turning point and falling from its peak (from 10% in 4Q09 to 9.7% in 1Q10). In addition, most of the available funds within fiscal packages have not yet been implemented, thus ensuring support to activity for the remainder of the year. However, there are mounting concerns about the sustainability of this impulse beyond 2010.

As a result of the cyclical improvement, growth prospects in the US and China have been revised. The US GDP growth rate for 2010 has been revised upwards since the beginning of the year to 3.0%, a figure at around its potential growth. On the other hand, the prospect of growth in China is reinforced and is similarly revised upwards to 9.8%. Against this background, not only do these countries benefit from the expansionary policies but also cause spill-over effects. For instance, as a result of the better outlook for the US in the short run, positive carry-over effects upon the Mexican economy are likely to be expected in 2010. Along this line, such an effect is estimated above 1 pp in 2010 yielding an upward revision of our estimates for the Mexican growth rates from 3.8% to 5%. However, the Mexican tax increase and lower than expected real wage performance generate doubts about domestic demand strength.

The remainder of Asian and Latin American countries have also benefited from these spill-over effects. Our GDP growth estimates for 2010 in Asia (excluding China) and major economies in South America have been accordingly revised upwards with respect to January from 5.1% to 6.0%, and from 2.3% to 2.9%, respectively (see Chart 4).

Chart 3

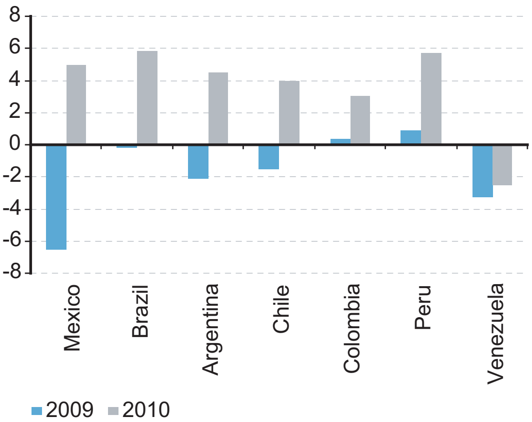
Trade and Commodity Prices (real terms)



Source: BBVA Research using CPB data

Chart 4

GDP growth forecast



Source: BBVA Research

On the negative side, heightened risk premia have spread from Europe. However, the European financial stabilization mechanism reduces uncertainties in the short-run

The negative spill-over effects from the uncertainty related to the heightened sovereign risk premia in Europe has emerged as other conflicting forces. This is a consequence of the high level of indebtedness of some of its countries and the doubts about the ability of the Eurozone to deal with them in its current decision-making framework. However, widening spreads and renewed financial stress may have reached a turning point in the short term from the approval of several measures, particularly the agreement on the European financial stabilization mechanism on 9th May at the European Council meeting, and also the IMF&EU agreement on Greece and the reinforced commitment to further consolidation in Portugal and Spain.

The European stabilization mechanism becomes an intelligent and satisfactory response to generate fiscal discipline in Europe. Since the creation of the Eurozone, none of the two available instruments to maintain fiscal discipline has worked properly. On the one hand, over the last few years, the fiscal discipline embodied in the Stability and Growth Pact (SGP) has proved to be insufficient. On the other hand, for many years the debt markets (market discipline) undervalued the potential risk emerging from public debt paths of some European economies. However, in the latest crisis, the market has differentiated among countries, but the movement has been excessive and has generated strong dynamics of financial instability.

The new tool is well designed to harmonize the mechanisms of market discipline and those resulting from fiscal discipline because it gives access to the stabilization fund, conditional on the implementation of a credible fiscal consolidation plan in the medium term. Thus, the Eurozone has created adequate and sufficiently powerful incentives for countries to embark on ambitious paths of fiscal consolidation.

If countries fail to give credible plans, they will be exposed to the market without the financial support of the entire EMU. This would rapidly increase the cost of debt, which would generate an acceleration of fiscal sustainability problems, and eventually, a domestic financial crisis. As a result, the disciplinary role of markets is strengthened by framing it within the rules of European budgetary stability.

Moreover, the ECB will implement additional measures to address severe tensions in financial markets. These measures mean a drastic shift in ECB policies. First, with the extension of the collateral framework, Greek bonds will be accepted regardless of rating, as they are close to the ECB illegible threshold after recent rating downgrades. Second, after the widespread contagion of sovereign markets' tensions to other credit markets, the ECB agreed on reintroducing the 3- and 6-month LTROs and reactivating the temporary liquidity swap lines with the Federal Reserve. Finally, following the closure of funding markets, the ECB has started to conduct interventions in the Eurozone public and private debt securities markets to purchase debt securities.

The sharp swing in ECB policies will probably maintain huge liquidity in the system for a long time, regardless of implementation issues. This means a downward pressure on short-term rates and a delay in the exit strategy of monetary policy.

The whole package has stabilized market conditions in the short run. The amount of funds is probably enough to keep Spain and Portugal out of the market, if needed. However, uncertainties remain in three main areas: i) the implementation of the rescue package in the months to come, ii) the credibility of further fiscal consolidation to be adopted by some EU countries and iii) EMU core countries' medium-term commitment to the package. In the short term, Europe's outlook is affected negatively due to higher risk premia, the further fiscal consolidation to be implemented in some countries and the implications of the recent episode of tensions on confidence.

As a consequence, the Eurozone growth expectations for 2010 remain almost unchanged, with a growth of 0.7% in 2010, and this area will lag behind other mature economies longer. Though these developments may impinge first on the European economy, negative spill-over effects into the rest of the world can not be ruled out.

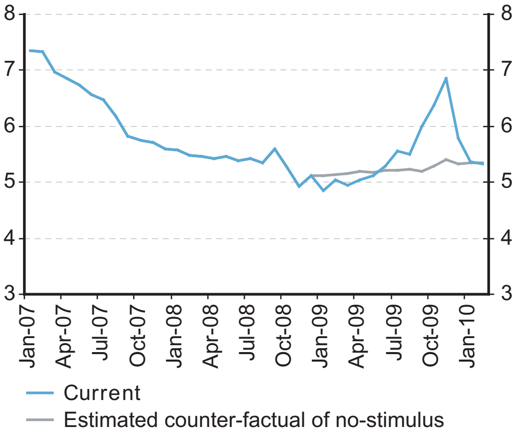
The sustainability of the recovery is not fully guaranteed beyond 2010, mainly in developed countries, following the short-term impulse from unprecedented fiscal and monetary expansion worldwide

While an ongoing economic recovery is spreading worldwide at the beginning of 2010, its intensity may evidence substantial heterogeneity across countries. The reason behind such different cycles has essentially to do with the way countries have faced the economic situation through the implementation of economic policy measures. In other words, the recovery's intensity across regions becomes the result of the distinct degrees of ease in their fiscal and monetary policies.

Even though a wide range of heterogeneous measures came up, these policies have been particularly instrumental in providing impulse to the cyclical upturn in China and the US as previously evidenced. The success stemming from unprecedented fiscal and monetary expansion by not only boosting activity but also by supporting income, has been greater than expected (see charts 5 and 6). However, as the implementation of several fiscal and monetary expansionary measures fades away, concerns about the sustainability of the recovery beyond 2010 are rising, particularly in advanced economies.

Chart 5

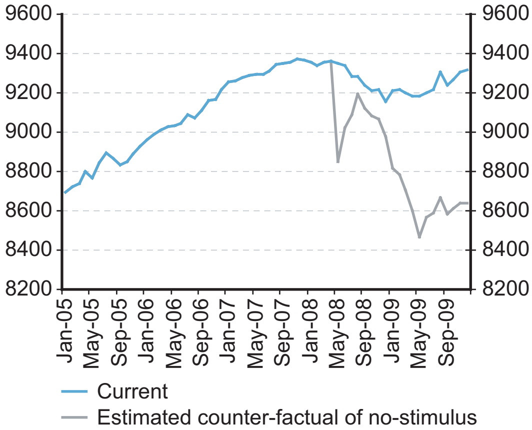
US: Home Sales (Millions)



Source: BBVA Research

Chart 6

US: Real Personal Consumption (USD, millions)



Source: BBVA Research

3. Growing divergence in monetary exit strategies

There exists a wide heterogeneity of cyclical conditions across regions. Consequently, strategies will differ: A gradual approach in the US, unclear exit timing for the EMU, and no one-size-fits-all strategy across emerging markets

In the US, even though economic growth may prove sluggish in 2010 and later, the risk of a double dip recession is limited, with inflationary pressures surfacing. On the contrary, in Europe, dismal growth prospects, financial risks and subdued inflation rates are likely to condition the ECB policy exit strategy for some time. In emerging markets the risk is tilted towards an overheating fuelled by an excessive delay in exit. As a result, different monetary exit strategies are expected to be implemented in each region.

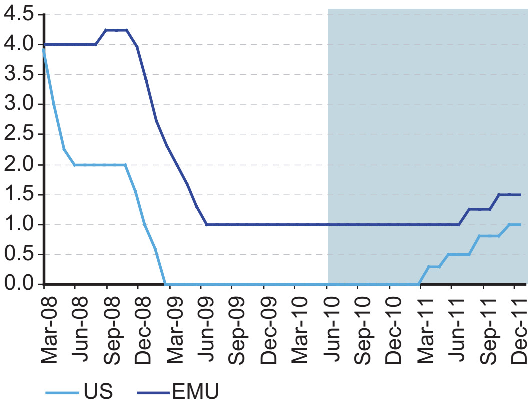
A gradual path of interest rate hikes is expected to commence by the beginning of 2011 in the US, as the Fed is likely to behave in a forward-looking manner in a context of weak fundamentals and incipient inflationary pressures

These upward movements in the US are encouraged by the acceleration in the pace of recovery, as private consumption indicators and the labor market conditions are improving. Since interest rates are at historically low levels, we envisage that the Fed will behave in a forward-looking manner, acting before cyclical indicators reach the same levels observed in previous episodes of tightening.

Notwithstanding, the path of tightening is likely to be gradual. In our baseline scenario, early rate hikes by the Fed are expected by the first quarter of 2011, whereas the market expects early hikes in 4Q10. Our view is based on a less positive medium-term outlook in terms of GDP growth as fundamentals still remain weak and the deleveraging process is still pending. These doubts also emerge as the main sources for the upward growth revisions in the US and are based on factors with only temporary effects as there are not enough signs that fundamentals will accompany the pace of recovery.

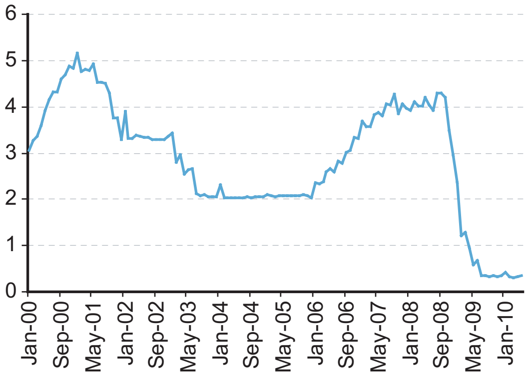
Moreover, the gradualism approach is conducted in a context of incipient inflationary pressures. Therefore, we expect rates to be slightly above 1% at the end of 2011 (see Chart 7). Only positive surprises from the labor market could accelerate this gradual trend.

Chart 7
Official Interest Rates in the US and EMU



Source: BBVA Research

Chart 8
EMU: Eonia



Source: Datastream

In order to manage the huge liquidity levels in the system, the Fed will use more intensively, among the set of non-conventional measures, the interest rate paid on excess reserve balances, with a predictable communication strategy

In addition, the Fed counts on a number of measures in order to manage the huge liquidity levels in the system and an orderly winding down of the non-conventional measures, such as: raising the interest rate paid on excess reserve balances (IOER rate), executing term reverse repurchase agreements (RRP) with the primary dealers, executing term RRP with a broader range of counterparties, using a term deposit facility (TDF) to absorb excess reserves, redeeming maturing and prepaid securities held by the Fed without reinvesting proceeds and selling securities held by the Federal Reserve before they mature.

Since a great deal of this liquidity is still materialized in excess reserves at the Fed, action should be taken on this front. In the policy toolkit at the Fed's disposal, a greater use of the IOER is likely. In fact, recent Fed moves are clearly geared to having a corridor (interval bounded by the discount rate and the IOER) defined by IOER.

Against this background, the communications strategy is also expected to be very predictable as the Fed will want to avoid any misguided expectations of a very fast tightening. The "extended period" wording is likely to remain until 4Q10. Then some reasonable changes are expected to occur progressively.

Action by the ECB is expected to come much later in view of fragilities of the European financial system, doubts about the strength of the recovery and low inflation levels

Conversely, in the Eurozone, dismal growth prospects, financial and sovereign risks and subdued inflation rates are likely to delay the ECB exit strategy policy for a protracted period of time. The weak economic recovery and subdued inflation in the Eurozone make it highly unlikely that the ECB could raise rates at any time before the second half of 2011. Domestic demand would remain very sluggish due to the weakness of the financial sector during 2010 and 2011. Core inflation is likely to decline slightly (around 0.5% in 2010 and 0.7% in 2011). These rates would be at the lowest levels since the creation of the Eurozone.

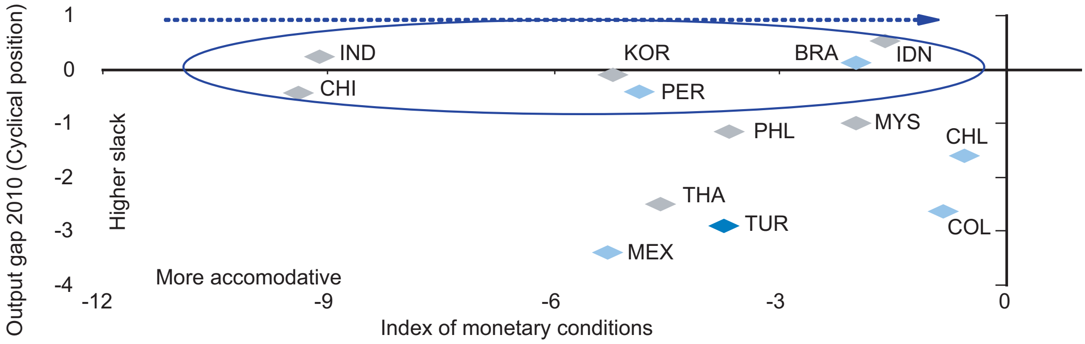
In particular, the current situation in European bond markets supports our view that the ECB faces a more difficult balancing act in terms of exiting current policies and, accordingly, of a long delay in terms of monetary tightening vis-à-vis the US. We foresee a protracted period of low level of Eonia interest rates in the EMU (see Chart 8).

Unlike the US and Europe, in emerging economies risks are related to overheating, which makes a faster exit necessary. However, as countries face different cyclical situations there is no one-size-fits-all way to implement this strategy

With respect to the emerging economies, there are few doubts about the short and medium-term growth. In this case, risks are more related to overheating and the measures authorities may undertake to cope with it. Recovery has been gaining momentum due to the expansionary policies implemented during the crisis period. As a result, in 2010 most of these economies are closing their negative output gaps very rapidly, as Chart 9 illustrates. Among them, note that there is a significant group of countries that should make further efforts in tightening monetary policy, particularly China and India.

Chart 9

Emerging markets: cyclical position vs. monetary conditions



Note: Countries within the circle show excessively accommodative monetary conditions given their OG levels. A more restrictive stance is advised particularly on these cases.
Source: BBVA Research

In this context, there are concerns about the timing of the withdrawal of monetary stimuli. In this region, apart from the classic factors that determine the optimal timing (cyclical position, inflation levels, fiscal position…) we should consider some other factors that might emerge as additional problems, such as asset bubbles and capital flows. However, given the different momentum situations faced by emerging economies, there is no one-size-fits-all way to implement an exit strategy.

However, there exists a delay in the monetary policy exit, especially in Asia, which is expected to continue in the future increasing the risk of overheating

In practice, the monetary stimulus is being removed very slowly from an ultra-accommodative stand notably in Asia, mainly through quantitative measures to cool the real estate sector and restrain credit growth, but without significant changes in interest rates.

Thus, despite the advanced cyclical position and the huge liquidity in these economies, several countries are delaying the exit or being less aggressive than required. The uncertainty of a reversal of global demand and perception of risk that may lead to a double dip recession, the absence of significant inflationary pressures (except for India and Brazil) and the electoral cycle in some LATAM countries have provided policymakers with arguments to delay the exit.

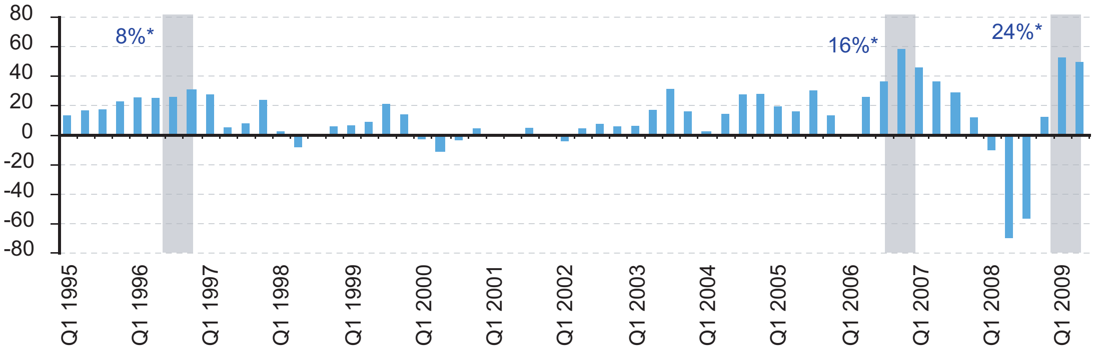
In the near future, we expect the withdrawal process to continue to be sluggish, tilting risks towards limited overheating, especially in Asia, where the need of a timely exit is more imperative, owing to an increasingly important contribution of domestic demand.

The stronger recovery in emerging economies is leading to a fall of risk premia and massive capital inflows, which might damage countries' competitiveness. Capital controls emerge as a possible tool, but they are likely to be ineffective in containing appreciatory pressures

At the same time, the better economic performance of these economies with respect to the advanced ones has led to a reduction in the relative risk premia in emerging markets, which allowed the return to the trend of growing capital inflows observed since 2002, only interrupted during the 2008 crisis (see Chart 10).

Chart 10

Emerging markets: Portfolio inflows (bn USD) and currency appreciation



Source: IFS and BBVA Research

* The value is the maximum appreciation registered during the flow surge period (simple average between key emerging countries: Argentina, Brazil, Mexico, Colombia, Chile, Peru, Venezuela, China, India, Indonesia, Malaysia, Korea, Thailand, Poland, Russian and Turkey).

Massive capital inflows are perceived to provoke adverse effects. From a macroeconomic viewpoint, they bring about appreciatory pressures that undermine countries' competitiveness. On the financial front, capital inflows may lead to excessive foreign currency exposure, possibly fuelling credit booms and asset bubbles.

Policymakers have traditionally opted for a mix of fiscal and monetary policies to reduce interest rates or a direct intervention in the foreign-exchange market through reserve accumulation (with sterilization if needed). One additional action available in the policy toolkit to manage inflows is the implementation of capital controls. However, controls are very likely to be ineffective, so that, in the absence of alternative policies, exchange rates will not resist the appreciatory pressures they are currently facing.

Consequently, in foreign-exchange markets, we expect an appreciation of currencies in most emerging economies. Despite the euro depreciation, the US dollar is going to lose value

In this context, the configuration of global FX markets has also undergone a significant shift in recent months, and their main features are expected to continue going forward. These features are: 1) Euro depreciation against all major currencies; 2) strong appreciation pressures for emerging markets, at least until contagion effects became clearer; 3) dollar depreciation on a trade-weighted real basis.

Regarding the first point, a key element of this realignment of global currencies is the depreciation of the euro vis-à-vis almost all major currencies. In the short term, this change has been clearly driven by risk aversion or, more generally, a negative perception among investors of the debt dynamics of several European countries and the handling of this situation by European institutions. However, underlying this trend there are also cyclical differences between the EMU and other regions (US, emerging), which are reflected, among other things, in the wide spreads between US and German yields. As such, even if risk aversion factors may recede in coming months, the risk of a return to previous levels in the EUR-USD cross should be limited.

At least until the contagion impact of recent weeks, the second trend in FX markets was strong appreciation pressures in emerging markets. This appreciation has a clear fundamental underpinning in the very optimistic prospects for growth in most of these economies, as commented before. This fundamental driver has been magnified by financial conditions. First, as a consequence of the crisis but probably likely to last, risks premia and volatility expectations in many developed nations have moved closer to those in emerging markets, altering the risk-reward profile favorably for the latter.

Secondly, and more dangerously, ample liquidity in developed nations is finding its way to emerging markets, in a context where low official rates in the US and EMU are reactivating "search for yield" and carry strategies. China is a leading case in this regard. Our view is that Chinese authorities will allow gradual appreciation of the renmimbi in coming months, in parallel with gradual hikes of official rates and further quantitative measures, while probably widening the bands for daily fluctuations in order to discourage excessive inflows. Other Asian currencies are also expected to appreciate, due to their strong cyclical situation, the tightening of their monetary policies and positive prospects for capital inflows. For Latin American currencies, given the large appreciation already experienced, it is expected that many central banks (particularly Brazil) will try to prevent the currency from further gains. The main exception in the region is Mexico, where the exchange rate still has appreciation potential given its comparatively more depreciated initial level and the improvement in the cyclical moment we forecast.

Finally, as a result of the previous trends, it is important to bear in mind that the dollar was, at least until recent weeks, depreciating on a real effective basis. The pattern whereby the dollar appreciates against the euro and other European currencies but depreciates against emerging currencies is consistent with relative cyclical differences but also with a medium-term correction of global imbalances. Accordingly, there are limited reasons to expect a significant reversion, except if risk aversion continues creating large contagion effects. That said, the medium-term uncertainties of the US economy suggest the process should, overall, be slower than it has been in recent months, so some reversion of recent dollar strengthening movements is still likely in the remainder of the year.

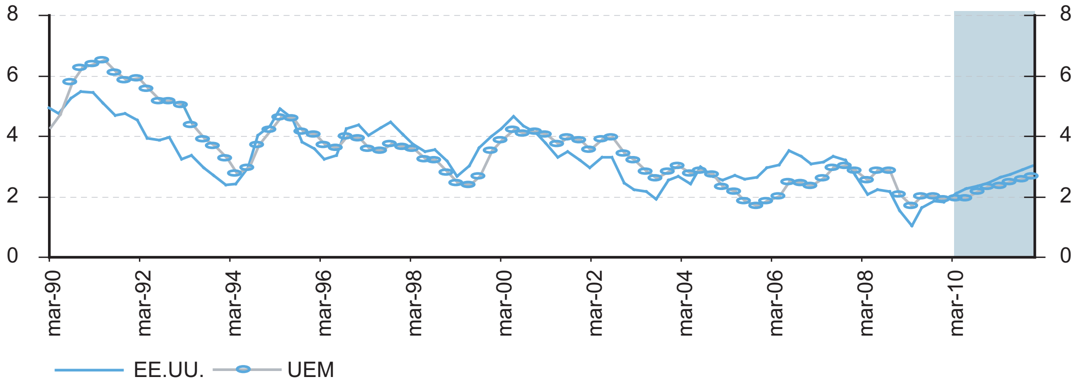
4. Markets showing the limits of countercyclical fiscal policies

The process of fiscal consolidation is uncovering the weaknesses of the European economy, where high risk premia should prevail in the market amid the uncertainty of the consequences of this process

The market perception of the fiscal policy has rapidly switched from the need for macroeconomic stimuli to the requirement of consolidating public accounts nowadays, particularly in Europe. Following the huge rescue package in Europe, some economies have reinforced their fiscal consolidation plans. However, the uncertainty around consolidation plans still generates some doubts as to the future dynamics of public debt. The heightened stock of both public debt (due to persistent deficits after the intensive use of fiscal countercyclical policy) and private debt (due to slow deleveraging) in some economies will push up real rates slightly (though these will remain at historically low levels, as shown in Chart 11), making these economies vulnerable to upward movements in interest rates and higher risk premia.

The main downward risk will be if agents' confidence is affected, jeopardizing the ongoing recovery and increasing the likelihood of a double dip recession.

Chart 11
Real interest rates



Source: BBVA Research
Note: Using a 5-year moving average of core inflation

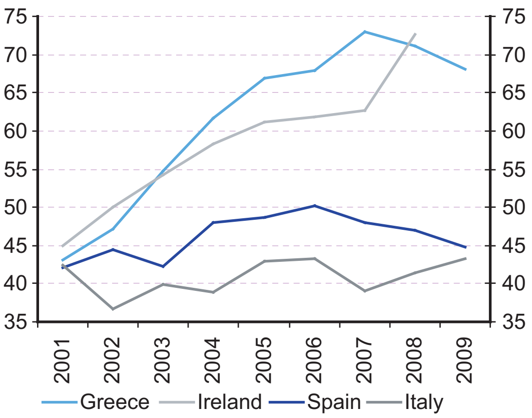
A clear result of the fragility of the current scenario has been the contagion to other countries. This will indeed be a major cause for concern in the near future. Economic history is fraught with examples of undue contagion from some countries to others in the aftermath of a crisis. In these cases, geographical linkages or cyclical similarities matter more than the differences in fundamentals.

A case in point is contagion to neighboring countries following the Argentine crisis. The negative side-effect in Chile was particularly unjustified: its economy boasted sound fundamentals and a well-known orthodoxy in the management of economic policies. There are also examples of unfounded contagion in developed countries. During the crisis of the Exchange Rate Mechanism (ERM) of the European Monetary System in the early nineties, the French franc was among the currencies most severely under pressure from international investors. The franc, unlike the pound, the lira or the peseta, resisted thanks to German financial support. However, several years later, in 1998, France joined the European Monetary Union with the same parity prevailing before the ERM crisis. The fact that this parity has remained obviously unchanged until now furnishes very strong evidence that the attack on the franc in the early nineties was not based on fundamentals; it was just an episode of undue contagion from other currencies with much weaker fundamentals.

The contagion from Greece to the rest of peripheral countries in Europe turns out to be another case of undue contagion

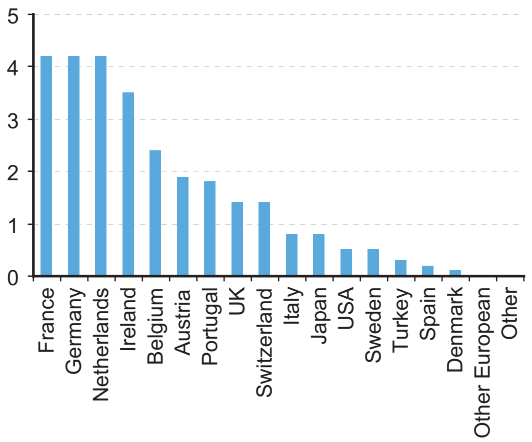
The current episode of market turbulence also shows clear indications of contagion. In fact, the Greek crisis has brought about substantial rebounds in the sovereign spread in other countries, such as Portugal, Ireland and Spain. However, this development is not fully justified either by the direct financial channel triggered by the Greek crisis or by any similarity in fundamentals. With regard to the first factor, the international exposure to Greek risk exhibits significant differences across countries. A substantial portion of the Greek debt is held by non-resident investors with more than 70% of the total outstanding debt. This is also the case of Ireland, whereas Spain and Italy exhibit a higher home bias and, as a result, are somewhat less reliant on foreign savers, as is shown in Chart 12. In fact, 80% of the total exposure to Greek debt is held by European banks. However, the data also show that European banks' exposure to Greece is quite different across countries (as shown in Chart 13), as is Spain's exposure to Greek.

Chart 12
General government debt held by non-residents (percentage of total outstanding debt)



Source: Central Banks and BBVA Research

Chart 13
Banks' exposure to Greek debt (% banks' capital)



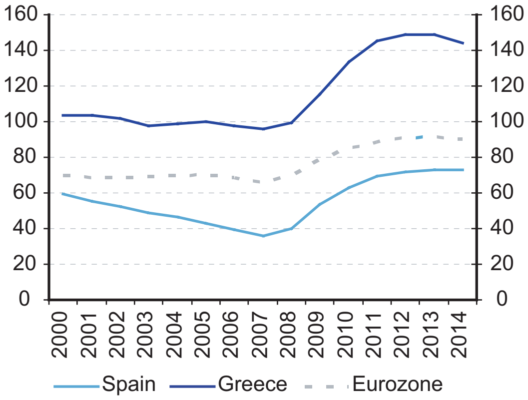
Source: IIF

Apart from this direct channel, fundamentals also diverge across these countries. In particular, Spain and Greece differ both on the fiscal side and on competitiveness fronts. With regards the former, the Spanish economy does not have a problem of public debt sustainability. The level of public debt is clearly below that of many European countries, including Greece (see Chart 14). Spain was one of the first countries in announcing a fiscal consolidation process before the Greek crisis started, and it has had a good track record in dealing with fiscal austerity plans in the past. In particular, the improvement of the primary structural fiscal balance is tantamount to the need at present to reach the 3% fiscal deficit target by 2013; no other European country can boast such a performance.

Moreover, on the competitiveness front, Spain's problems are far less acute. Its export share has increased, and the adjustment of the current account deficit is quite impressive, as shown in Chart 15. Contrary to what has occurred in countries with persistent external imbalances such as Greece (with a current account deficit holding at 12%) and Portugal (with a deficit increasing to 10%), the Spanish current account deficit has narrowed down from 10% of GDP in 2008 to below 4% in early 2010. Various facts underlie this development. First, in Spain the private sector has already undertaken much of the necessary adjustment. In particular, Spain, unlike other economies, experienced a surge in investment during the boom times, which is currently being corrected at a fast pace. Second, going forward, Spain will not have persistent financing needs compared to those required by other countries. This should give rise to very different debt sustainability paths.

Chart 14

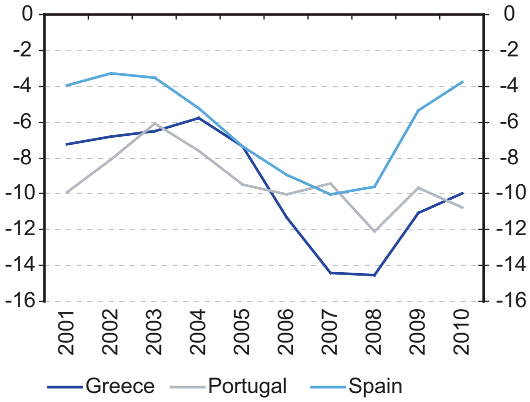
General government debt



Source: Eurostat and BBVA Research

Chart 15

Current account balance (% of GDP)



Source: Datastream

In sum, even though some countries are under pressure from international investors, the severe contagion from the Greek crisis is difficult to justify on the grounds of fundamentals. However, in order to overcome this situation, countries affected by the contagion are obliged to make additional efforts to safeguard their credibility and reinforce their strong commitment to fiscal sustainability and structural reforms. Following the release of the financial stabilization mechanism in Europe, Spain and Portugal, particularly, are in the markets' focus. As a consequence, these economies have reinforced their commitment to face additional actions of fiscal adjustment. Spain's government has recently announced that it will anticipate the consolidation effort by additionally reducing its deficit target by 0.5% in 2010 and 1% in 2011. Similarly, Portugal has announced additional measures to make further progress on fiscal adjustment (additional deficit cut of 1% in 2010 and 1.5% in 2011).

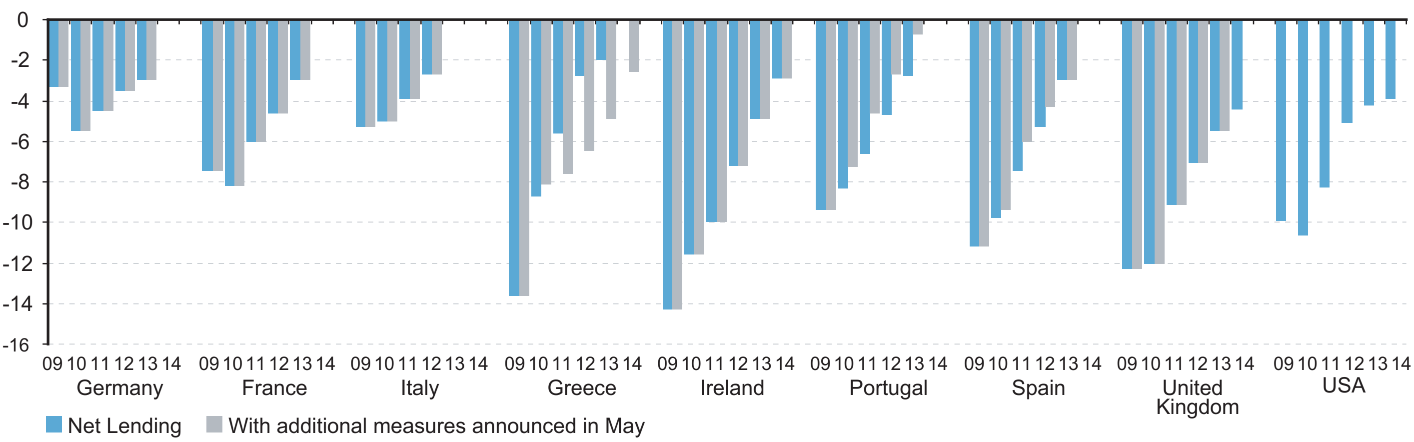
5. Long-run fiscal consolidation challenge for developed countries

Uncertainties about the effects of rising public debt draw attention towards the plans of fiscal consolidation amid an environment of high risk premia

Beyond short-term urgencies, there are increasing concerns about the long-term consequences of rising public debt levels, which draw attention towards the process of fiscal consolidation. As we observe in Chart 16, the deterioration of fiscal positions has been widespread. Similarly, consolidation plans have been set off across the board, albeit with significant differences.

Some countries like Germany, France and Italy face consolidation from a less stressed position, even France, which starts off with relatively high deficit levels. Germany is applying additional stimuli in 2010. Setting aside the case of Greece, Ireland and Portugal are putting forward a very gradual consolidation path and leaving most of the adjustment for the final part of the period. Spain, on the other hand, is starting the consolidation in 2010, with a strong deficit correction, although it is very similar to the one carried out in the previous fiscal consolidation period which ended with a 2% budget surplus in 2007.

Chart 16
Projected deficit plans presented to the EC



Source: National Government to EC January 2010, announcement in May and CBO for the US

Outside the Eurozone, the consolidation has already started, but at a very slow pace. The UK started from a huge deficit position and, in the absence of the details of the plan that the new government will implement, the consolidation will be moderate. In the US, the consolidation is also slow, and the last figures released by the CBO point at a 4% level to be attained in 2020. In these time horizons, some factors can apply even more pressure. All developed countries face increases in expenditures derived from population aging and national health systems.

The availability of adjustment tools and a flexible economy are key factors that allow for an increase in credibility and confidence while containing market pressures, as is the case in the UK and US

The heterogeneity in the exit speed of the expansionary fiscal policies and the different market responses reveal that confidence and credibility are key principles to having sufficient leeway in the implementation of economies policies. Outside the Eurozone, for instance, the situation in the UK and the US are paradigmatic, since they can afford to very slowly phase out their stimulus programs even though they run huge budget deficits. These countries have a flexible economy and a strong institutional structure with the credibility required to carry out the measures to rapidly correct the situation if needed.

In a nutshell, all these elements point in the same direction: high risk premia for a protracted period and the need for further consolidation efforts and structural reforms that enhance countries' competitiveness.

There will be increasing differentiation among those countries which can control their fiscal variables credibly and those which cannot

A recent risk aversion episode is adding a "flight to quality" premium in most European countries' bonds, and even if some moderation occurs, this is likely to be a lasting phenomenon. Even if recent contagion movements gradually fade away, increased discrimination across countries depending on their fiscal situation is likely to remain relevant. In line with this, increasing differentiation among those countries that can control their fiscal variables credibly and those which cannot is to be expected. This process, if conducted in an orderly way, should be seen in a positive light, as market discipline mechanisms will still provide the correct incentives to governments, which did not occur in the past.

6. Slow financial restructuring and regulatory process possibly jeopardizing the recovery

Beyond the current and future situation in the markets, the other main source of uncertainty comes from the financial sector, for two different reasons. On the one hand, there are increasing concerns about the sluggish restructuring of the financial sector. On the other hand, there is a lot of uncertainty regarding the ongoing regulatory reform. Both factors are likely to restrict the availability of credit in the future.

The restructuring of the financial sector, especially in Europe, is occurring too slowly. This raises concerns going forward

The sluggishness of the restructuring of the financial industry is raising concerns, particularly in Europe, where in 2009 some economies only bought time and put off the appropriate measures for tackling the problems that the financial industry still suffers.

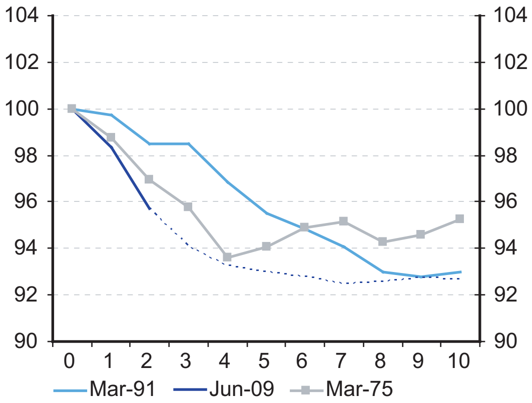
Until now, in some economies the financial sector has seen windows of opportunity and taken advantage of some elements that has eased the pressure on the sector. First, the extraordinary monetary policy measures (in terms of both lower rates and abundant liquidity) has created a cheap way of funding, but there has also been a shortening in issuance maturity.

Second, a slow process of write-down recognition, the slow reduction of exposure to structured assets and the restructuring of loans, have maintained the non-performing loan rate at relatively low levels, improving the performance of the financial sector. These are temporary effects, particularly taking into account the usual lag that the peak in NPL shows over the cycle, especially in Europe, where the NPL cycle lags behind the US by one year.

In this context, the provision of credit will be notably affected, in comparison with other recovery periods. In view of the importance of the credit channel in the first stages of economic upturns, there is an increasing risk of facing a creditless recovery, which can constitute a potential drag on growth, particularly for the Eurozone

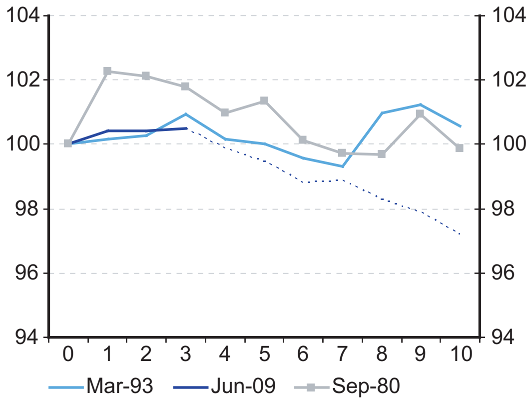
A growing concern related to the slow restructuring of the financial sector is the possibility of facing a deeper creditless recovery than expected, i.e., a lack of credit to fuel the early stages of economic growth. So far, credit in all regions has showed a trend of moderation over the last quarters. In the US in particular, the downward trend has been deeper, with some credit segments registering strong falls, and to a lesser extent in the Eurozone. After three consecutive quarters of growth in the US and the Eurozone, credit is still weak. This is the result of several factors, such as the deleveraging process and the fragility of the financial sector. According to our estimates, the credit channel will not boost the economy in the current cycle, and the credit over GDP ratio will continue decreasing in the coming quarters, more intensively than in any other cycle (see Charts 17 and 18). This is a growing concern, since historical experiences and our own simulations show the importance of the credit channel to spur economic growth, particularly when economies face the early stages of growth. In short, a creditless recovery is a risk factor, and a potential drag on the economy, particularly for the Eurozone.

Chart 17
USA: Real total credit over GDP in different cycles (=100 at the beginning of each recovery)



Source: BBVA Research, based on BEA and Fed

Chart 18
EMU: Real total credit over GDP in different cycles (=100 at the beginning of each recovery)



Source: BBVA Research based on Eurostat and ECB

The ongoing regulatory reform is likely to hinder the ability of the banking sector to provide credit in the future. The most probable scenario consists of increases in capital and liquidity requirements and additional measures to control systemic risk

With respect to the second factor, the ongoing regulatory reform entails some uncertainties for the financial industry going forward, especially as the final outcome remains a very open issue, with a broad range of proposals coming from different institutions. Against this background, our central scenario encompasses some elements that minimise the potential risks of the reform. In particular, this scenario relies on the leading role of the Financial Stability Board (FSB), with a dilution of national initiatives or with a certain degree of accommodation of some national initiatives within the framework of the FSB. As a result, a global approach seems to be guaranteed to some extent, thereby minimising the risks of regulatory fragmentation.

In this scenario, the deadline for the FSB is November, when the G20 meeting is scheduled to be held in Seoul. The expected outcome in November is the adoption of additional capital and liquidity surcharges for the banking sector in line with the proposal known as Basel III.

Our concerns regarding this regulatory scenario are the following: First, a fragmentation in the implementation phase is feasible if extensive grandfathering clauses or long transition periods are admitted at a national level. This will increase room for arbitrage opportunities. Second, a break in the global decision-making framework could undermine the level playing field. Finally, over-regulation, with a menu of different measures alongside Basel III, will impinge on credit markets, with particularly undue consequences on emerging markets, thereby jeopardizing the ongoing bancarization process. In order to avoid this scenario, the result of the quantitative impact studies should be taken into account. Assessing the cumulative impact of the proposed regulatory changes is the optimal way to combine a greater financial stability with limited impact on credit and economic growth.

7. Tables

Table 1

Macroeconomic Forecasts: Gross Domestic Product

(YoY growth rate)	2007	2008	2009	2010	2011
United States	2.1	0.4	-2.4	3.0	2.5
EMU	2.7	0.5	-4.0	0.7	1.3
Germany	2.6	1.0	-4.9	1.0	1.3
France	2.3	0.3	-2.2	1.2	1.3
Italy	1.4	-1.3	-5.1	0.6	1.1
Spain	3.6	0.9	-3.6	-0.5	1.0
UK	2.6	0.5	-4.9	0.8	1.5
Latin America *	5.8	4.0	-2.5	4.6	4.0
Mexico	3.3	1.5	-6.6	5.0	3.8
LatAm5 **	7.8	5.0	-1.4	2.9	3.6
Asia	7.3	4.0	1.8	5.8	5.3
China	14.2	9.6	8.7	9.8	9.2
Asia (exc. China)	5.1	2.1	-0.8	4.2	3.8
World	5.3	3.0	-0.7	4.2	4.1

Source: BBVA Research
Forecast closing date: 30th April 2010
* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela
** Argentina, Chile, Colombia, Peru, Venezuela

Table 2

Macroeconomic Forecasts: Inflation (Avg.)

(YoY growth rate)	2007	2008	2009	2010	2011
United States	2.9	3.8	-0.4	2.0	1.8
EMU	2.1	3.3	0.3	1.0	1.2
Germany	2.3	2.8	0.2	0.7	1.0
France	1.6	3.2	0.1	1.3	1.4
Italy	2.0	3.5	0.8	1.6	1.8
Spain	2.8	4.1	-0.3	1.2	1.6
UK	2.3	3.6	2.2	2.7	1.7
Latin America *	6.0	9.0	7.4	6.3	6.4
Mexico	4.0	5.1	5.3	5.1	4.4
LatAm5 **	10.6	16.5	12.5	9.0	16.0
Asia	2.8	4.9	0.2	2.9	2.6
China	4.8	5.9	-0.7	3.1	3.3
Asia (exc. China)	2.1	4.6	0.6	2.8	2.4
World	4.1	6.1	2.2	3.7	3.4

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

Table 3

Macroeconomic Forecasts: Current Account (% GDP)

	2007	2008	2009	2010	2011
United States	-5.2	-4.9	-3.0	-3.4	-3.8
EMU	0.1	-1.1	-0.8	-0.6	-0.5
Germany	7.9	6.6	5.0	4.8	4.8
France	-2.3	-3.3	-2.9	-3.3	-3.6
Italy	-2.4	-3.4	-3.4	-2.9	-2.8
Spain	-10.0	-9.7	-5.4	-2.9	-1.4
UK	-2.7	-1.5	-1.3	-1.8	-2.0
Latin America *	0.9	-0.4	-0.1	-0.9	-1.7
Mexico	-0.9	-1.6	-0.6	-0.7	-1.7
LatAm5 **	2.7	2.5	2.1	1.3	0.3
Asia	5.6	4.1	3.9	3.3	2.9
China	10.9	9.6	6.0	5.6	5.0
Asia (exc. China)	3.6	2.1	3.1	2.4	2.1

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

Table 4

Macroeconomic Forecasts: Government Deficit (% GDP)

	2007	2008	2009	2010	2011
United States	-1.2	-3.2	-9.9	-10.6	-8.4
EMU	-0.6	-2.0	-6.3	-6.6	-5.2
Germany	0.2	0.0	-3.3	-5.5	-4.5
France	-2.7	-3.3	-7.5	-8.2	-6.0
Italy	-1.5	-2.7	-5.3	-5.0	-3.9
Spain	1.9	-4.1	-11.4	-10.4	-8.7
UK	-2.8	-4.9	-11.5	-12.0	-9.1
Latin America *	-0.7	-1.1	-3.2	-2.8	-2.5
Mexico	-1.1	-2.1	-3.2	-3.6	-3.3
LatAm5 **	2.1	0.7	-2.9	-2.2	-2.2
Asia	-0.3	-2.4	-5.5	-5.6	-5.0
China	2.2	1.4	-0.9	-2.8	-2.8
Asia (exc. China)	-1.3	-3.8	-7.2	-6.7	-5.8

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

Table 5

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

	2007	2008	2009	2010	2011
United States	4.6	3.6	3.2	3.9	4.3
EMU	4.2	4.0	3.3	3.3	3.6

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	1.2
UK	2.0	1.8	1.6	1.5	1.4
China	7.6	6.9	6.8	6.7	6.4

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	0.1	1.3
EMU	4.0	2.5	1.0	1.0	1.5
China	6.9	6.9	5.3	5.6	6.0

Source: BBVA Research

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This report has been produced by the Economic Scenarios Unit

Chief Economist
Mayte Ledo
+34 91 374 40 75
teresa.ledo@grupobbva.com

Rodrigo Falbo
+34 91 537 39 77
rodrigo.falbo@grupobbva.com

Jaime Martinez-Martin
+34 91 537 47 54
j.martinez.martin@grupobbva.com

Alejandro Fernandez Cerezo
+34 91 374 99 24
alejandro.fernandez.cerezo@grupobbva.com

Jorge Rodriguez Valez
+34 91 537 48 90
jorge.rv@grupobbva.com

With the contribution of :

Financial Scenarios Unit
Ignacio González Panizo
+34 91 374 67 61
ignacio.gonzalez-panizo@grupobbva.com

Cross-Country *Emerging Markets* Analysis
Sonsoles Castillo
+34 91 374 44 32
s.castillo@grupobbva.com

Europe
Miguel Jiménez
+34 91 537 37 76
mjimenezg@grupobbva.com

Financial Systems
Ana Rubio
+34 91 374 33 42
arubiog@grupobbva.com

BBVA Research

Group Chief Economist
José Luis Escrivá

Chief Economists & Chief Strategists:

Regulatory Affairs, Financial and Economic Scenarios:
Mayte Ledo
teresa.ledo@grupobbva.com

Financial Scenarios
Daniel Navia
daniel.navia@grupobbva.com

Financial Systems
Ana Rubio
arubiog@grupobbva.com

Regulatory Affairs

Economic Scenarios

Market & Client Strategy:
Antonio Pulido
ant.pulido@grupobbva.com

Equity and Credit
Ana Munera
ana.munera@grupobbva.com

Interest Rates, Currencies and Commodities
Luis Enrique Rodríguez
luisen.rodriguez@grupobbva.com

Asset Management
Henrik Lumholdt
henrik.lumholdt@grupobbva.com

Spain and Europe:
Rafael Doménech
r.domenech@grupobbva.com

Spain
Miguel Cardoso
miguel.cardoso@grupobbva.com

Europe
Miguel Jiménez
mjimenezg@grupobbva.com

United States and Mexico:
Jorge Sicilia
j.sicilia@bbva.bancomer.com

United States
Nathaniel Karp
nathaniel.karp@bbvacompass.com

Mexico
Adolfo Albo
a.albo@bbva.bancomer.com

Macro Analysis Mexico
Julián Cubero
juan.cubero@bbva.bancomer.com

Emerging Markets:
Alicia García-Herrero
alicia.garcia-herrero@bbva.com.hk

Cross-Country *Emerging Markets* Analysis
Sonsoles Castillo
s.castillo@grupobbva.com

Pensions
David Tuesta
david.tuesta@grupobbva.com

Asia
Stephen Schwartz
stephen.schwartz@bbva.com.hk

South America
Joaquín Vial
jvial@bbva.cl

Argentina
Gloria Sorensen
gsorensen@bancofrances.com.ar

Chile
Alejandro Puente
apuente@grupobbva.cl

Colombia
Juana Téllez
juana.tellez@bbva.com.co

Peru
Hugo Perea
hperea@grupobbva.com.pe

Venezuela
Oswaldo López
oswaldo_lopez@provincial.com

Contact details

BBVA Research
Paseo Castellana, 81 - 7th floor
28046 Madrid (Spain)
Tel.: 91 374 60 00 y 91 537 70 00
Fax: 91 374 30 25
bbvaresearch@grupobbva.com
www.bbvaresearch.com
Legal Deposit: 31256-2000