BBVA Research

Global Economic Outlook

Decouplings at play

First quarter 2011

8 February 2011

Main messages

Global Economic Outlook

Decouplings at play

- The global economy is expected to continue growing strongly, with most of the dynamism still coming from emerging economies, decoupling from advanced countries.
- But also within advanced economies there are increasing growth divergences: the US will keep growing more than strongly than Europe, and within Europe, core countries are starting to grow stronger than peripherals.
- This will increase differences in policies, increase capital flows, put downward pressure on the euro in the long-run and complicate monetary policy in Europe.
- Risks of a double dip in the US have faded, and the growth outlook has improved markedly, but delayed fiscal consolidation increases risks of a sharp market reaction in the long-run.
- In Europe, a window of opportunity seems to open up to solve the fiscal and financial crisis. Institutional reforms in EU governance are essential and are needed quickly. But countries need to continue implementing reforms, including, most importantly, in the financial system.
- Growth decoupling within Europe will not last if these reforms are not implemented soon. Core countries would also be dragged down if tensions in Europe are renewed.
- Commodity prices will stabilize around current levels, limiting their pressure on headline inflation. However, risks are tilted to the upside.
- Asia and Latin America will continue growing strongly, on track for a mild slowdown. However, risks of overheating have increased, as domestic demand will grow strongly and capital inflows are set to increase.

Outline

Global Economic Outlook

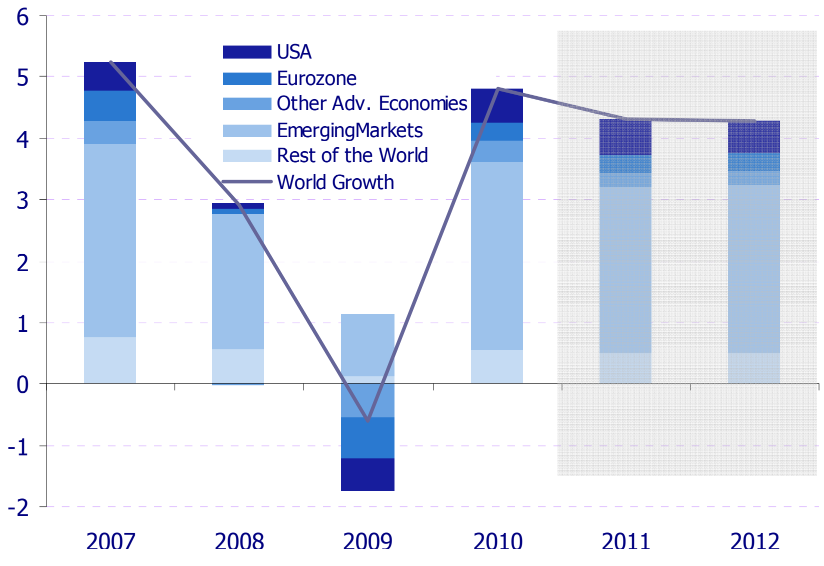
Decouplings at play

Section I
A tale of many decouplings

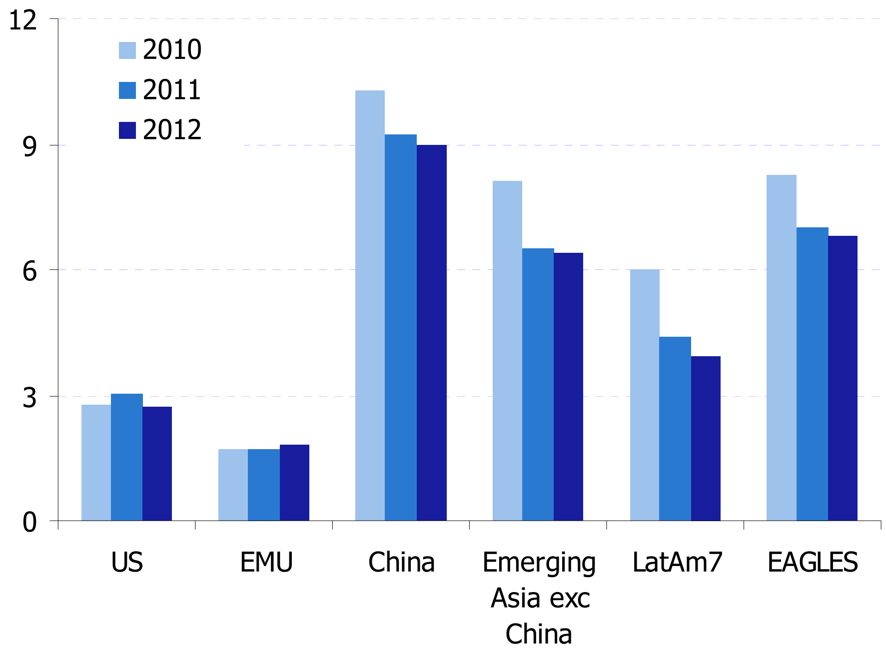
The world will continue growing strongly, but increasing its decouplings, both in terms of growth …

- The global economy is expected to continue growing strongly, by 4,4% in 2011 and 2012.
- Most of the dynamism will continue to come from emerging countries in Asia and Latin America (especially the EAGLEs©), which will keep decoupling from advanced economies.
- But also within advanced economies there are increasing growth divergences: US will keep growing more than strongly than Europe, and within Europe, core countries are starting to grow stronger than peripherals.

Contributions to Global Growth
Source: BBVA Research



GDP growth forecasts
Source: BBVA Research



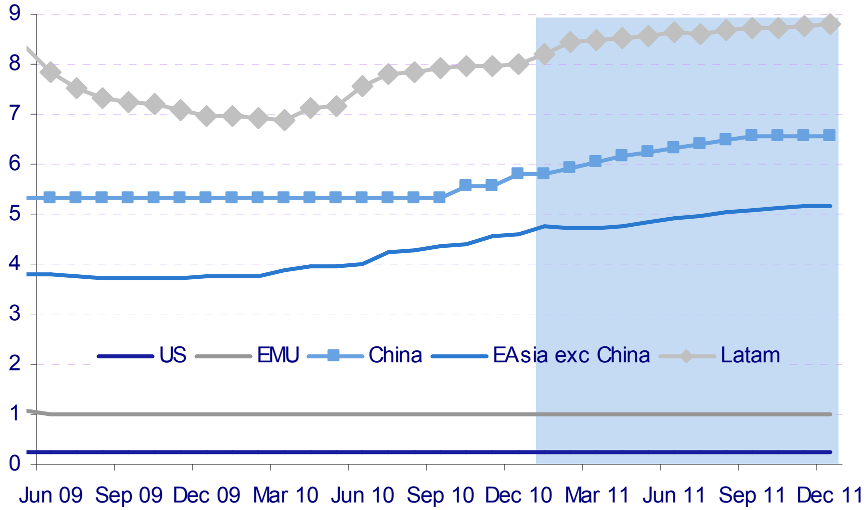
Section I
A tale of many decouplings

… and also decoupling in terms of policies

- Growth decouplings have important implications for the outlook:
  - Increasing divergence in policy stance between advanced and emerging economies. Most notably on monetary policy, which will remain on hold in the former.
  - Increasing risks of overheating in emerging economies, fuelled in part by the likely renewal of strong capital inflows.
  - Long-term downward pressure on the euro vis-à-vis the dollar and market attention to Europe's difficulty to grow out of debt.
  - More difficulties for managing a common monetary policy for a decoupled Europe.

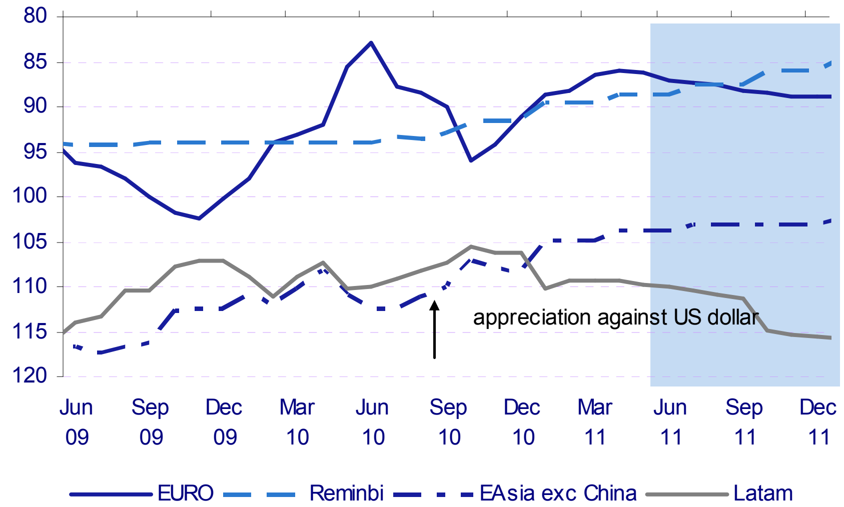
Official interest rates

Source: BBVA Research



Bilateral Exchange Rates against US$ (Index 2008=100)

Source: BBVA Research and Bureau of Labor Statistics



Outline

Global Economic Outlook

Decouplings at play

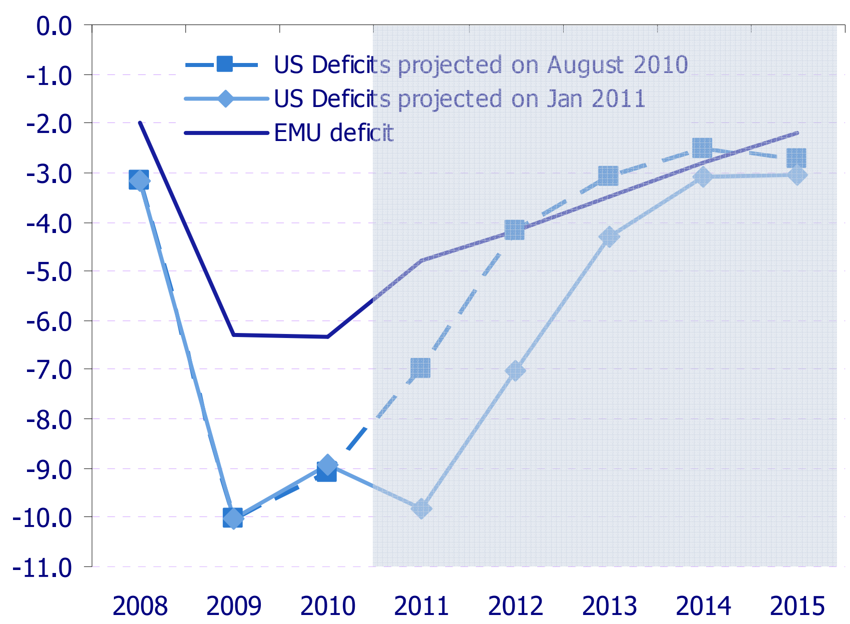
Section II
US outlook improves

The risk of a double dip in the US has faded.

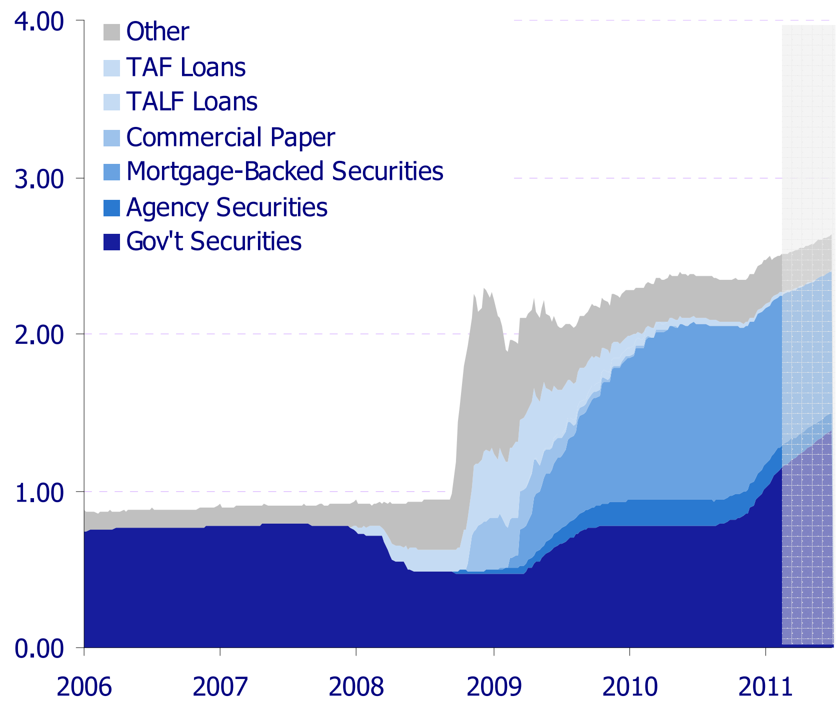
In part that was due to renewed policy support…

- Chances of a double dip in the US, which we thought were very low, have faded.
- Two important factors behind the improved outlook for growth were renewed policy stimulus:
  - The Federal reserve restarted a program of bond purchases (QE2) to reduce long-term yields
  - A new fiscal stimulus, which would increase growth by around 0,5% in 2011

US and EMU public deficits (% of GDP)
Source: BBVA Research and CBO



Federal Reserve Balance Sheet (USD bn)
Source: BBVA Research and, Federal Reserve

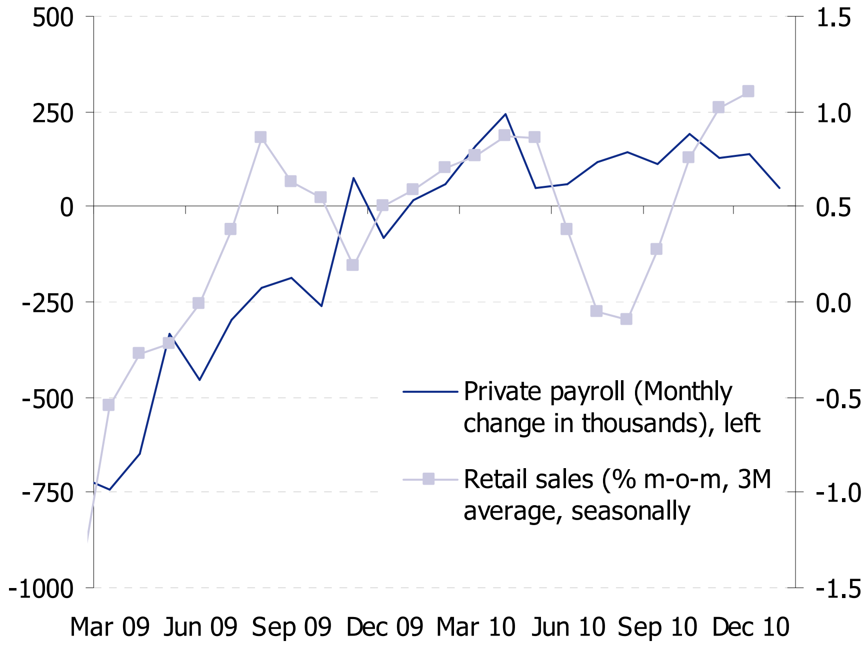


Section II
US outlook improves

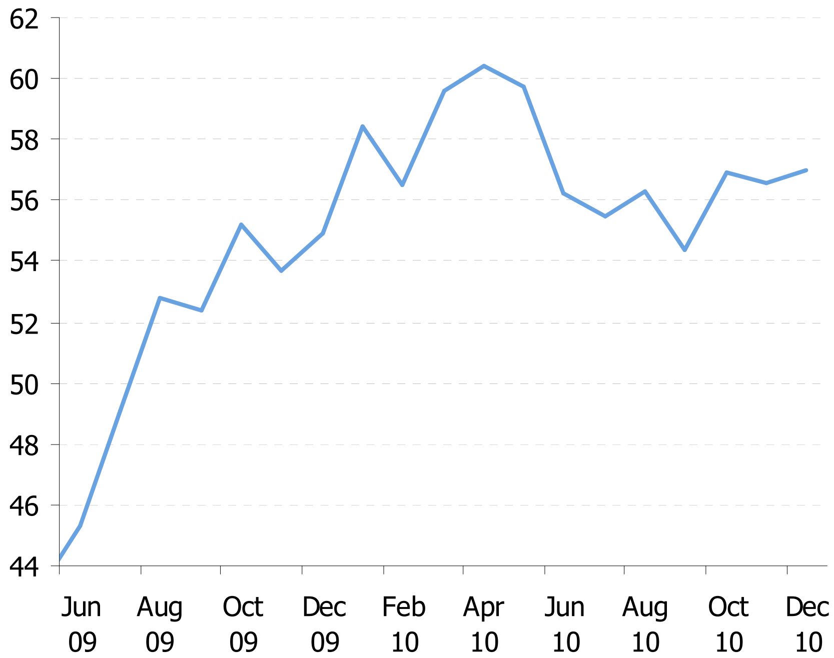
… and also because of better macro data and reduced uncertainty

- In addition to policy stimulus, macroeconomic data after the summer turned out to be stronger than expected, especially as regards consumption (durable goods in particular) and the labor market.
- Furthermore, reduced regulatory and tax uncertainty after the elections contributed to an increase in business confidence, which should boost investment going forward.
- All these factors induce an upward revision of growth forecasts for 2011 and 2012, with risks tilted to the upside.

US: Employment and retail sales
Source: BBVA Research, Datastream and Bloomberg



US: Business confidence
Source: BBVA Research and haver Analytics



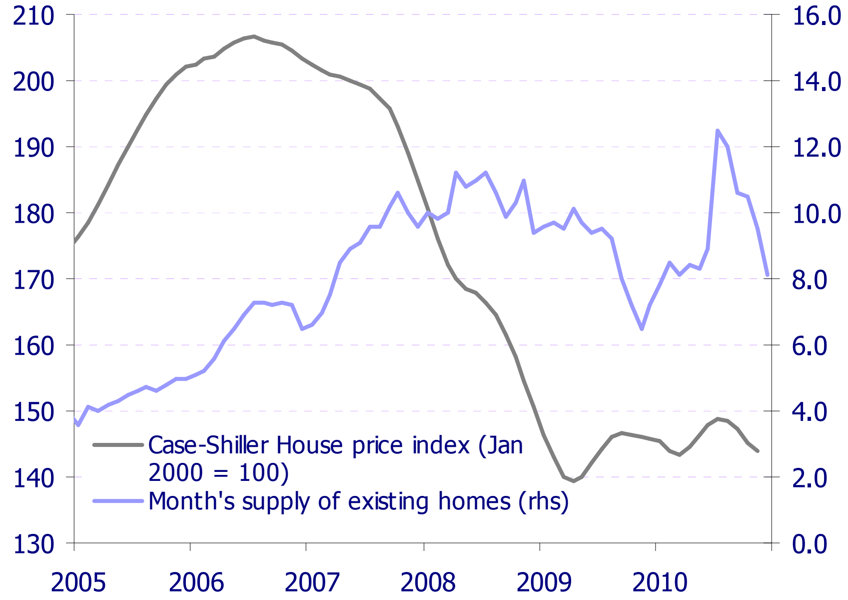
Section II
US outlook improves

But the recovery still has vulnerable spots

- However, the recovery in the US still has vulnerable spots:
  - The housing market remains weak, with a sizable inventory of houses on sale, depressed prices and the risk of more supply coming from a backlog of foreclosures.
  - Recovery is not fast enough to significantly reduce unemployment rates
  - Therefore, household income is still sluggish.

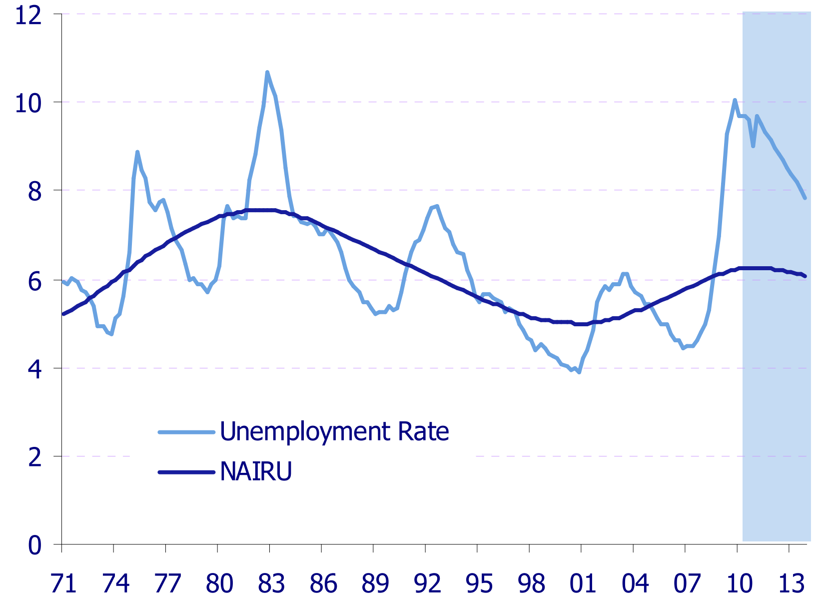
US: House prices and inventories

Source: BBVA Research and Haver analytics



US: Unemployment Rate

Source: BBVA Research and Bureau of Labor Statistics



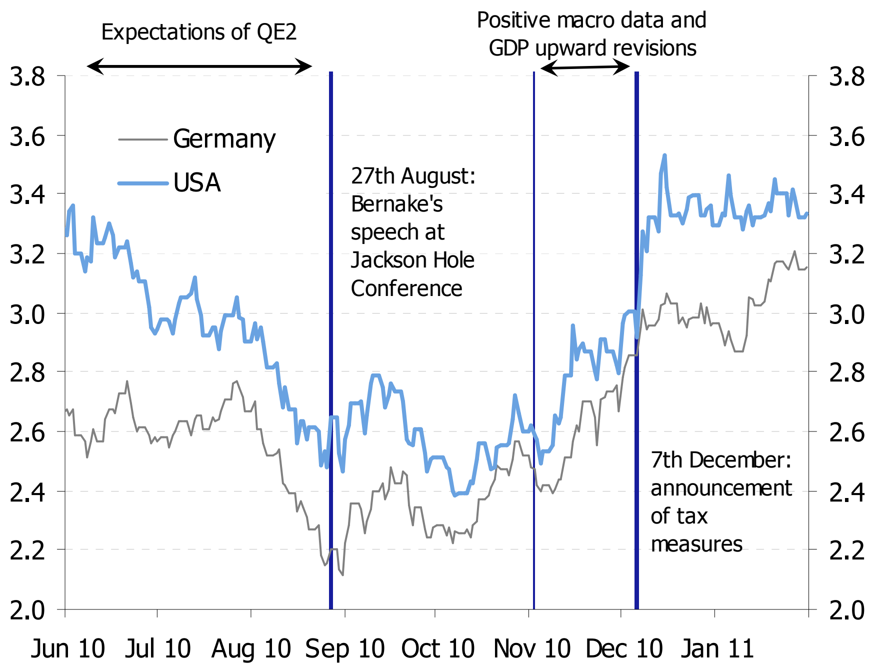
Section II
US outlook improves

Recent increases in long-term interest rates reflect a better growth outlook …

- The recent increase in bond yields can be attributed mostly to a better growth outlook.
- The postponement of fiscal consolidation raises the specter of a negative reaction by markets, but a number of factors have prevented that increase. Some of them are structural in nature, but perhaps the most important ones will be maintained only in the short run.
- The risk is that these short-run factors will not be permanently in place to support low long-term yields.

Long-term interest rates (10yr)

Source: BBVA Research and Bloomberg



Why is market pressure for US consolidation lower than in EMU?

Structural
- Strong, unified institutions
- Higher potential GDP growth than EMU
- Banking crisis addressed

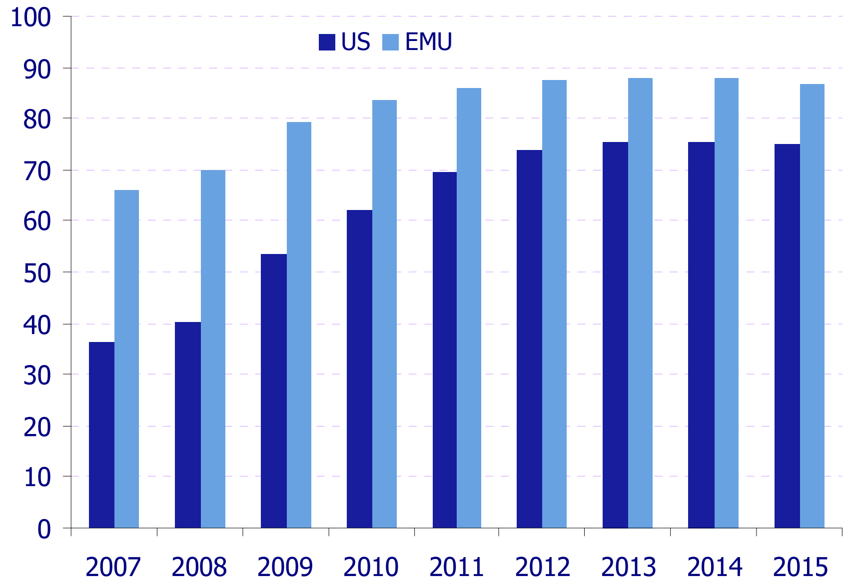
Short Run
- Flight to safety in periods of financial stress
- Purchases of debt (and Agencies) by Fed (QE1 + QE2)
- Investment in US assets for foreign reserve accumulation

Section II
US outlook improves

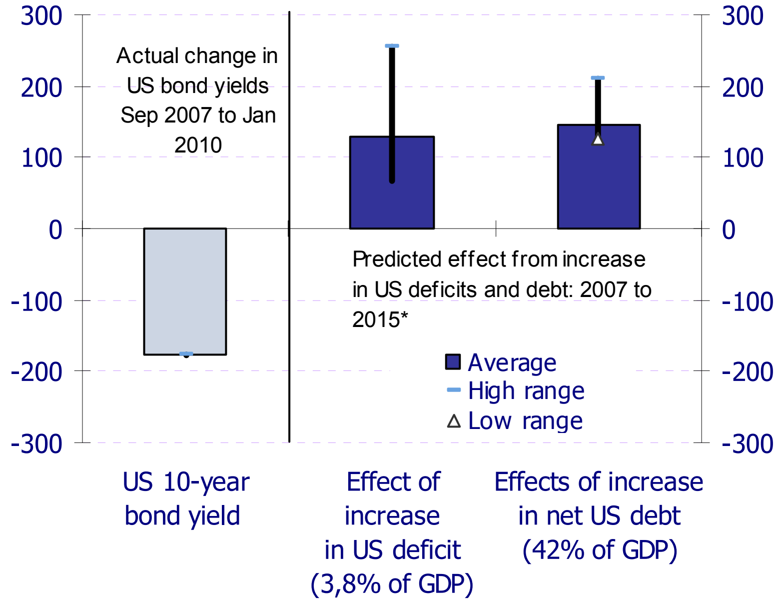
…but new risks emerge in the long run from the delay in fiscal consolidation

- The historical experience shows that higher debt and deficit ratios are associated with a sizable increase in long-term yields, precisely the opposite of what has happened since the beginning of the crisis.

US and EMU public debt
Source: BBVA Research and CBO



US: Actual and predicted changes in 10-yr bond yields
Source: BBVA Research and various authors*



* As estimated by Gale and Orzag (2004), Laubach (2009), Engen and Hubbard (2004) and Thomas and Wu (2009).

Outline

Global Economic Outlook

Decouplings at play

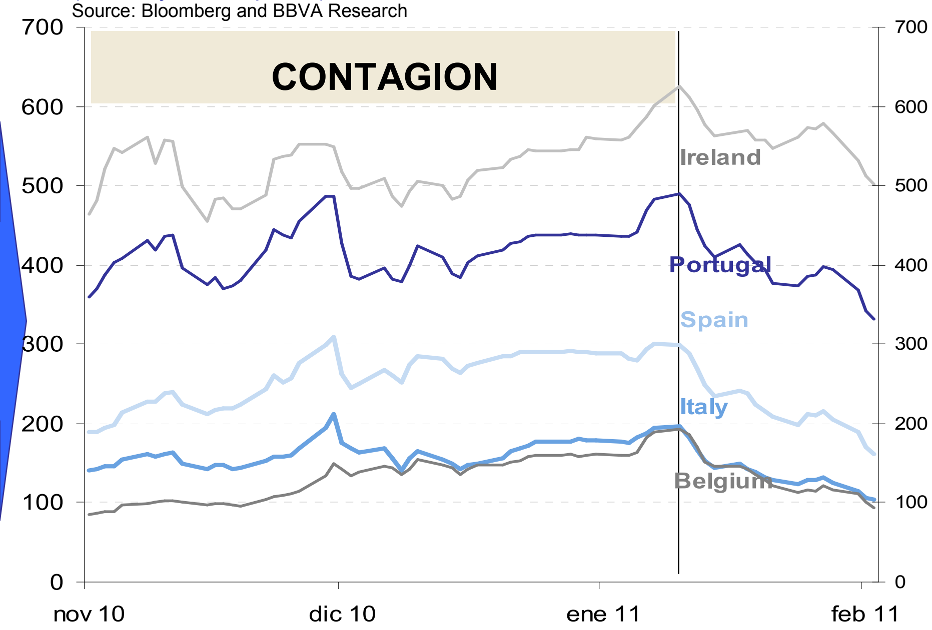
Section III
A window of opportunity for Europe

Doubts about true health of financial sector and ability of European institutions to solve the debt crisis led to renewed funding pressures

- Financial tensions in Europe surged again, triggered by reduced confidence in the ability of European institutions to deal with sovereign debt crises. Private investors were afraid they would bear losses on possible debt restructurings.
- Moreover, the credibility of stress tests were in doubt given that Ireland had to support its banks shortly after they were deemed adequately capitalized
- These landed on top of doubts about achieving fiscal targets and on the ability of Europe to grow out of its public debt. But a window of opportunity has opened up since mid-January

- **Since October, more doubts on:**
- **Europe's governance, private bail-ins and transition periods**
- **Credibility of stress tests given performance of Irish banks**
- **On top of existing doubts about:**
- **Achievement of fiscal consolidation targets (Portugal, Ireland)**
- **Capacity to "grow out of debt"**

CDS Spreads with Germany
(CDS 5-yr, basis points)
Source: Bloomberg and BBVA Research



Section III
A window of opportunity for Europe

These tensions highlight the need for comprehensive crisis prevention and crisis resolution mechanisms

Crisis resolution in the short run: addressing liquidity and solvency problems to restore market confidence once and for all

Liquidity problems	**Improve EFSF in quantity (a size than cannot be tested by markets) and quality (used to lower bond yields / lent at lower interest rates)**
Solvency problems	**EC should determine which countries are not solvent (debt ratios might be too high in some countries)**
	For insolvent countries, debt should be reduced **Conditionality increased (especially structural reforms, banking reforms)**

In the long run: Designing a strong framework of crisis prevention (reinforced fiscal coordination) and crisis resolution to apply once the crisis is over

Crisis prevention	**European Stability Mechanism: New SGP including debt levels, macro imbalances. Reinforced sanctions. Key: make sanctions fully automatic**
	Increase possibility of fiscal transfers, as shock absorbers
	Eurobonds covering a sizable portion of national debt, but an important part to be issued separately, to keep market discipline
Crisis resolution	**Bail-in mechanisms (lower rates, extension of maturities, CACs**

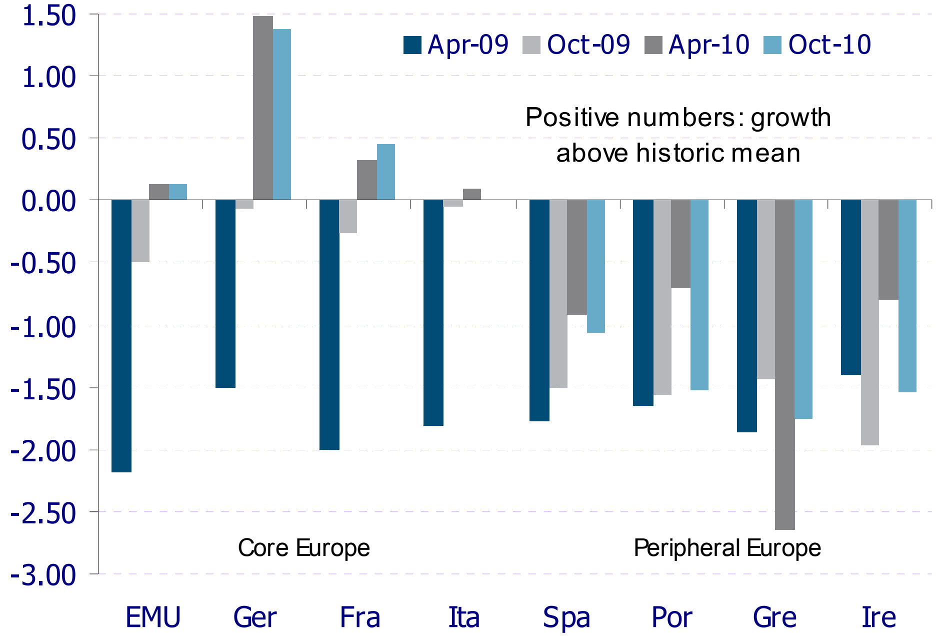
Section III
A window of opportunity for Europe

Spillovers from financial tensions to economic activity have been limited to far, but they may not last unless crisis is solved fast.

- Until now, financial tensions in the periphery have not translated into core countries, nor to economic activity.
- Economic activity has remained more or less stable in peripheral countries, but the recovery has surprised to the upside in core Europe, especially Germany. This prompts a revised growth projection for the EMU as a whole, but with different prospects between core and periphery.
- However, this decoupling will not last if EU economic governance is not reformed comprehensively and economic reform is pushed in key areas, including the financial system.

BBVA synthetic indicator of economic activity in EMU

Source: BBVA Research



Outline

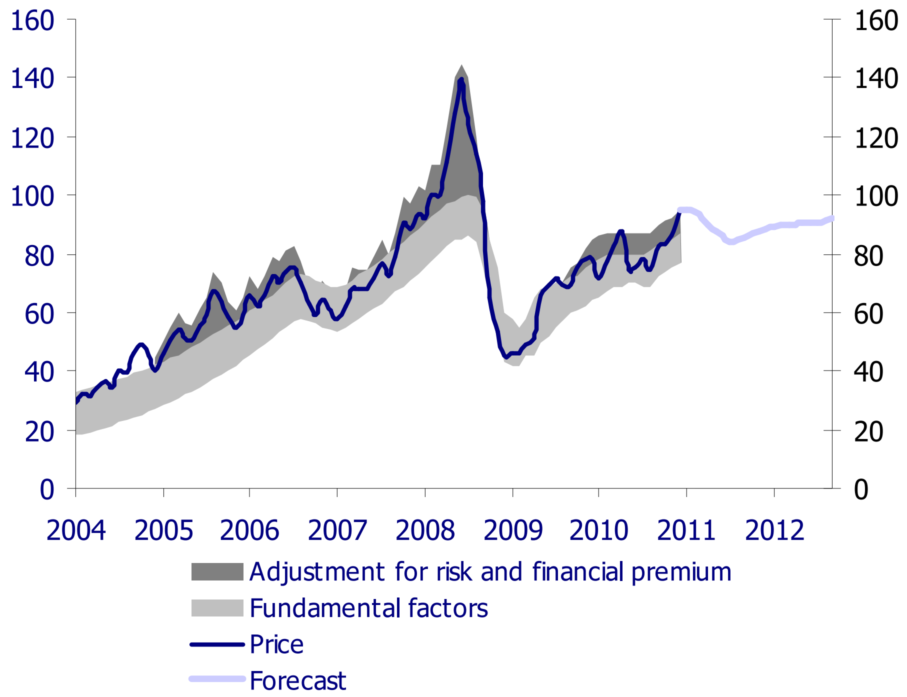
Section IV
Overheating risks in Emerging Economies

Commodity prices have surged recently, but they will level off.

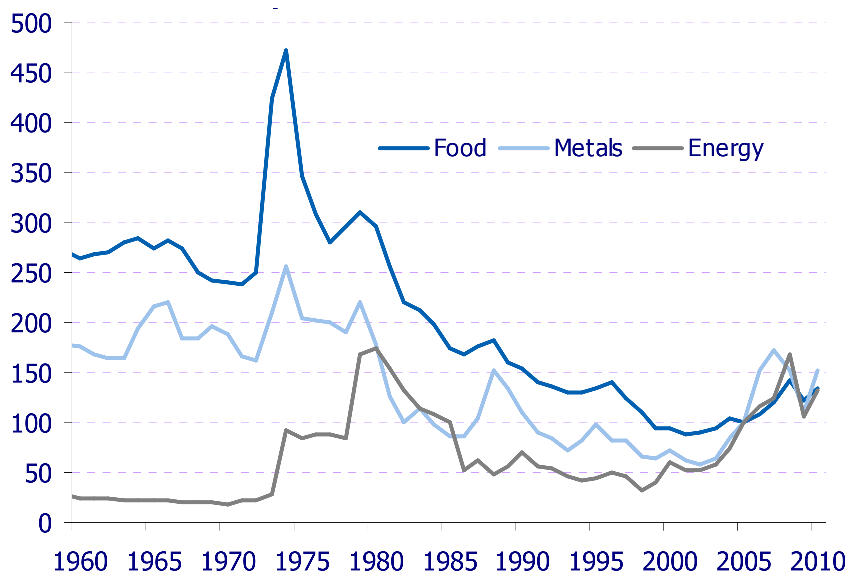
- Commodity prices have surged in recent months, mostly due to short-term supply factors (weather, political instability) and investment flows into commodity markets.
- Going forward, we expect these factors to wind down as crops normalize and Europe's financial tensions abate, although geopolitical instability remains a risk to commodity prices
- Risks are tilted to the upside, also because strong demand from Asia will continue to support an upward trend in prices started at the beginning of last decade.

However, risks are tilted to the upside

Oil price (Brent, USD per barrel)
Source: Datastream, Bloomberg and BBVA Research



Commodity prices in real terms (2005=100)
Adjusted for US inflation. Source: BBVA Research and IMF



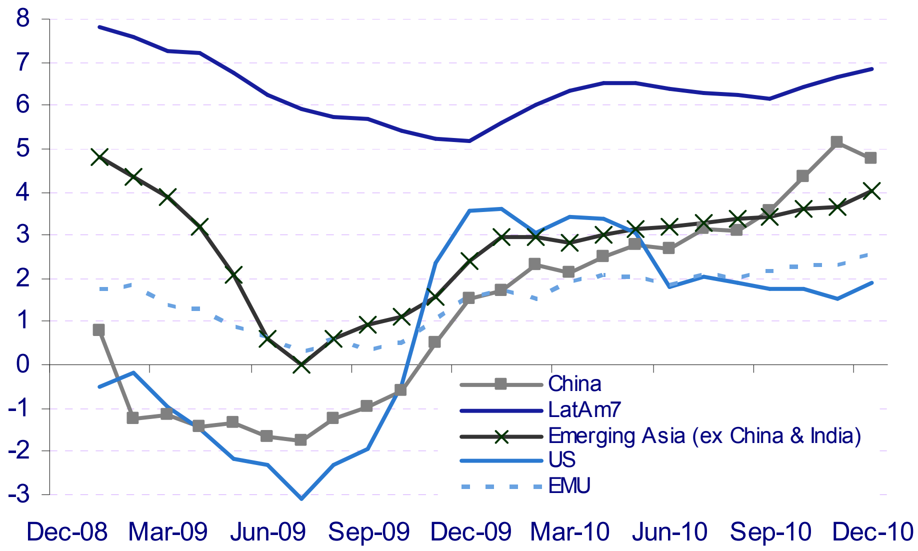
Section IV
Overheating risks in Emerging Economies

Overheating pressures are surfacing in Emerging Economies

- Commodity prices has been responsible in part for the global increase in inflation, especially in emerging economies, where food represents a bigger share of consumption.
- The leveling of commodity prices will mean that this factor will become less important for headline inflation.
- Inflation risks from commodity prices are tilted to the upside, but are heterogeneous across countries, depending on starting inflation and the weight of food on their CPI.

Inflation (%y-o-y)

Source: BBVA Research and Datastream



Risks from first-round effects of an additional increase in food prices

Source: BBVA Research

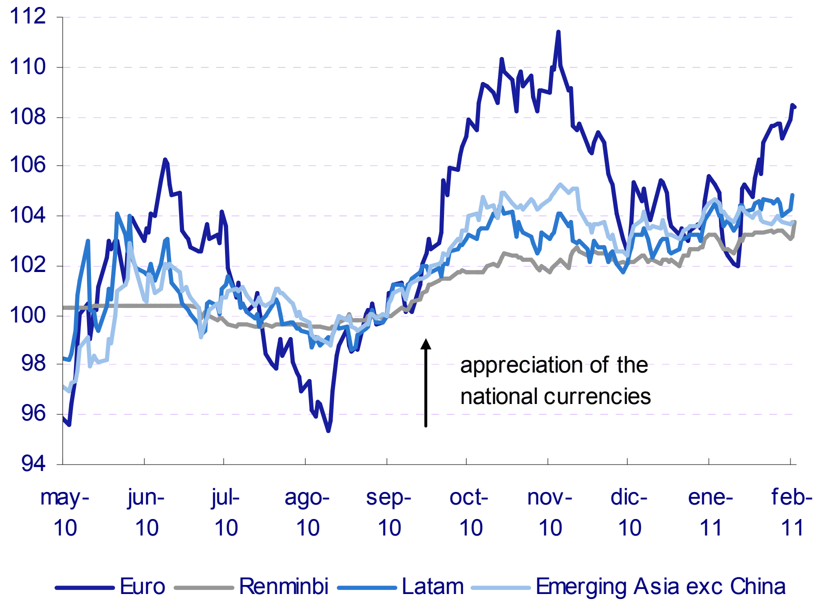
Low Risk	Medium Risk	High Risk
Chile	Mexico Colombia	Brazil Peru
S.Korea	China Philippines Indonesia	India Turkey Vietnam

Section IV
Overheating risks in Emerging Economies

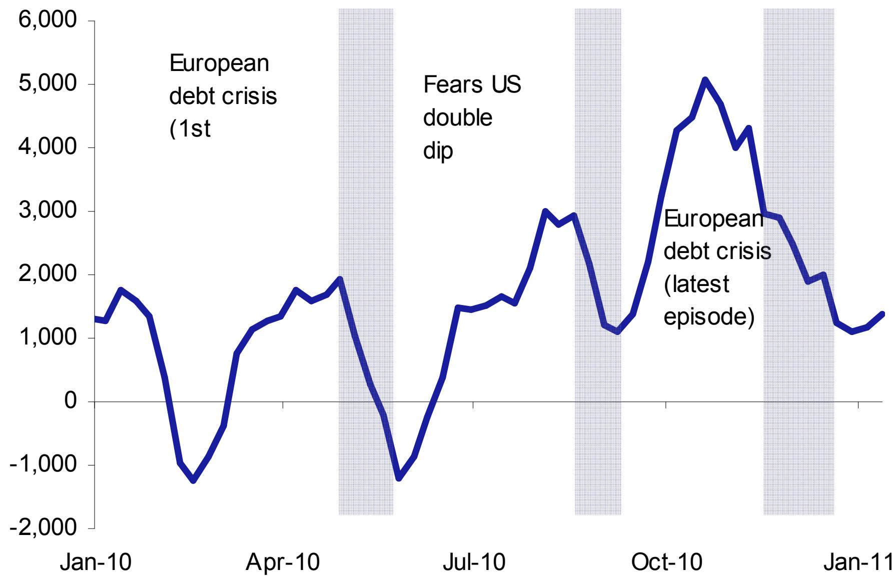
And policy dilemmas will increase going forward

- Rapid growth in emerging economies and strong capital inflows are starting to generate overheating pressures, evident in higher inflation but also on strong credit growth and increasing asset prices.
- Asia and Latin America are poised to grow strongly and we expect both regions to avoid overheating, although the risk is higher than last year.
- We expect policy to continue tightening in both areas, but policy dilemmas will increase as capital flows resume after a respite during the increase in European tensions. Appreciating pressures, which subsided during the fourth quarter of 2010, will also resume.

Bilateral exchange rates to the US dollar
Source: BBVA Research and haver analytics



Equity capital flows to emerging economies
Source: BBVA Research and EPFR



Main messages

Global Economic Outlook

Decouplings at play

- The global economy is expected to continue growing strongly, with most of the dynamism still coming from emerging economies, decoupling from advanced countries.
- But also within advanced economies there are increasing growth divergences: the US will keep growing more than strongly than Europe, and within Europe, core countries are starting to grow stronger than peripherals.
- This will increase differences in policies, increase capital flows, put downward pressure on the euro in the long-run and complicate monetary policy in Europe.
- Risks of a double dip in the US have faded, and the growth outlook has improved markedly, but delayed fiscal consolidation increases risks of a sharp market reaction in the long-run.
- In Europe, a window of opportunity seems to open up to solve the fiscal and financial crisis. Institutional reforms in EU governance are essential and are needed quickly. But countries need to continue implementing reforms, including, most importantly, in the financial system.
- Growth decoupling within Europe will not last if these reforms are not implemented soon. Core countries would also be dragged down if tensions in Europe are renewed.
- Commodity prices will stabilize around current levels, limiting their pressure on headline inflation. However, risks are tilted to the upside.
- Asia and Latin America will continue growing strongly, on track for a mild slowdown. However, risks of overheating have increased, as domestic demand will grow strongly and capital inflows are set to increase.

BBVA Research

Global Economic Outlook

Decouplings at play

First quarter 2011

8 February 2011