# International Environment

## Moderate slowdown in the two drivers for world economic growth

In 2005, the world economy will experience its third consecutive year of expansion although at a lower growth rate than during 2004. This is the result of less expansive monetary conditions and the impact of higher energy prices. Given this environment, it can be expected that the United States and China will continue to gradually adjust their interest rates at less accommodating levels as they have been doing since mid 2004. This process could begin in 2005 in the European Monetary Union countries. This outlook is based on the continuation of solid growth in the United States and China, which are functioning as drivers of world economic activity. In this context of bipolar growth, however, the risk is that one of these two drivers (if not both) could fail.

For China, the uncertainty is whether, as anticipated, growth will be gradually moderated, preventing an abrupt adjustment in activity from occurring. In this context, there is good news: the beginning of the rising interest rate cycle has revived some expectations that progress is being made toward market mechanisms and that an appreciation of the Chinese currency against to the dollar could take place in the next few months.

In terms of the United States, the risk involves a possible adjustment of the current account deficit that is perceived to be increasingly untenable, especially given that the disparities in the current account balances between countries grows year by year. In a scenario in which no announcements are being made concerning measures to control the fiscal deficit, the possibility cannot be ruled out that the necessary adjustments will continue to occur via the financial variables. In this sense, the depreciation of the dollar and the increase in the spread between U.S. and European Monetary Union interest rates could be reflecting less commitment to continuing to finance the growing U.S. trade deficit. If this continues, it could result in inflationary pressures that would force the Fed to adjust its benchmark interest rates more rapidly than initially anticipated and therefore, would lead to lower economic growth.

## In 2005, the U.S. economy will grow at a lower rate

During the first three quarters of 2004, the U.S. economy grew at an annual rate of 4.6%, between 1 pp and 1.5 pp above its potential growth. This growth can be attributed to the continued dynamism of private consumer spending and the strong boost in investment, especially in equipment and software. Nevertheless, signs of moderation are beginning to accumulate, confirmed by the trend toward more modest growth in quarterly GDP during 2004.

Our outlook for 2005 is of lower domestic demand, both in investment as well as consumption. Investment is growing at rates higher than its long term trend in a context in which the output gap is already positive, which implies that economic growth could already have reached its maximum level in the current expansive cycle, and that in the future these rates will register more moderate levels. However, companies' financial strength and the improvement in business confidence will help maintain high investment rates in 2005, although lower than those in 2004.

### U.S.: Base Scenario

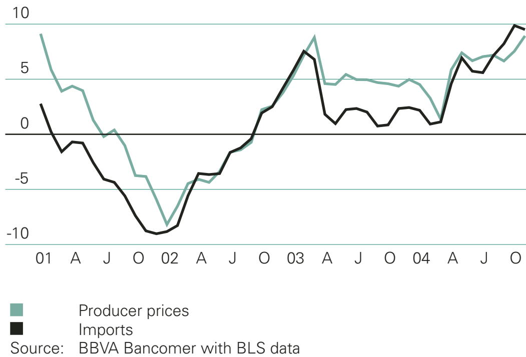
| | Real ann.% chge. | | Contribution, pp | |
|---|---|---|---|---|
| | 2004 | 2005 | 2004 | 2005 |
| **GDP** | **4.4** | **3.5** | **4.4** | **3.5** |
| Private consumption | 3.7 | 3.5 | 2.6 | 2.5 |
| Gross fixed investment | 12.5 | 5.8 | 2.0 | 1.0 |
| Net total exports | 10.9 | 3.9 | -0.5 | -0.2 |
| Government spending | 2.0 | 1.9 | 0.4 | 0.3 |
| **Inflation (%)** | | | | |
| Headline, average | 2.7 | 2.2 | | |
| Core, average | 1.8 | 1.9 | | |

Source: BBVA Bancomer

### U.S.: Corporate Earnings and Non-farm Payroll

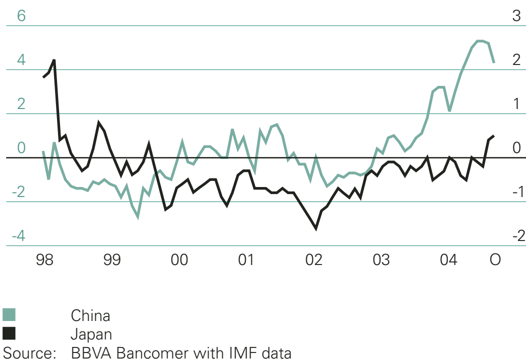
Non-financial corporate earnings after taxes (US$ billions)
Non-farm payroll, millions of persons
Source: BBVA Bancomer with BEA and BLS data

## U.S.: Producer and Import Prices
Annual % change




Producer prices
Imports
Source: BBVA Bancomer with BLS data

## Annual Inflation
%




China
Japan
Source: BBVA Bancomer with IMF data

The lower economic growth in the upcoming quarters will also be sustained by less expansion of private consumer spending. The exhaustion of the monetary stimulus and the moderation in increased fiscal efforts, both implemented in the past three years, support this prognosis. The rise in real interest rates will lead to a decrease in wealth and motivate families to increase their savings, currently at historic low levels. Growth rates will continue, supported by the continued recovery in employment, particularly in the services sector and the positive increase in real payment for hours worked. The lower growth in private consumer spending, together with our expectation of a reduction in prices for energy and raw materials, will allow for more moderate trade and current account deficits. For the economy as a whole, we expect growth of 3.5% in 2005.

### Inflation will continue to be low, although there are risks of a rise in prices

After a year of strong increases in energy prices, the moderation in economic activity could limit inflationary pressures. This seems to be, at least, analysts' estimate. According to the Consensus Forecasts survey, average inflation projected in November 2004 for 2005 was 2.4%, 0.3% higher than the January 2004 estimate.

The balance for inflation indicates more upward than downward risks. To begin with, there is the depreciation of the dollar and the increase in prices of raw materials. In this sense, it is worthwhile to pay attention to one of the channels that helped diminish price increases in the United States in the past, namely, the low inflation in Asian countries. In the past few months and in a context of exchange interventions, the greater liquidity in these countries, due to resistance to the appreciation of their currencies, is generating greater inflation. Secondly, the cyclical position of the economy (with a positive output gap) could, contrary to what occurred in 2004, end up leading to a growing number of companies transferring the cost increases to final prices.

We can already begin to see these pressures. Of particular importance in the past few months was the inflection in price trends for non-energy industrial goods, which are posting positive annual growth rates, something that has not occurred since November 2001 and that could continue in the future. Some of these pressures, however, could be compensated by the favorable evolution of inflation in the service sector, if it continues to be supported by less pressure from communications prices.

### The Fed will continue eliminating its accommodating monetary policy

In this scenario, in 2005, the Fed will continue the monetary restriction. The pace at which the monetary authorities will raise interest rates and the impact that these increases will have on the rest of the financial assets are two key issues for 2005.

Since June 2004, two and a half years after the beginning of the expansive phase of economic activity, the Fed has continually increased federal funds rates. They have done so even though on many occasions the monetary authorities speculated with the possibility that once the level of official rates was reached that would nullify real interest rates, they would stop increasing yields.

There are reasons to believe that far from halting this adjustment, what we will see in 2005 are continued increases in interest rates. In the first place, due to the relative strength in economic activity. In the second place, because the downside risks on inflation have given way to upside risks, as a result of the cyclical position of the economy and the development of import prices. Furthermore, it seems probable that the monetary authorities will change the current neutral thrust in inflation to a policy favoring a rise in prices in their initial meetings of 2005.

Finally, the very depreciation of the dollar is causing a monetary relaxation that for the moment is compensating the rises in real interest rates in the United States. The tone in monetary policy continues, therefore, to be accommodating as it reflects the low interest rates and the exchange weakness.

Everything indicates that the official interest rates will reach levels of 4% at the end of 2005, much closer to the real rate levels that are considered "neutral." The pace of increases will be relatively even in the year, with gradual hikes of a quarter of a point and with the possibility of a pause only in the second half of 2005. In this scenario, it is assumed that the dollar-euro exchange rate will depreciate 7% compared to the 2004 average (1.33 in 2005 vs. 1.24 in 2004).

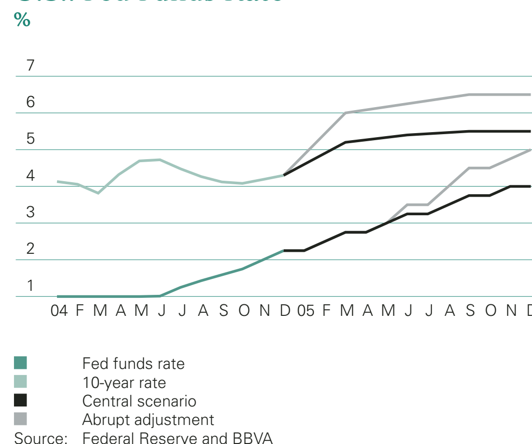
The other key question is the impact of the monetary adjustment on other assets, especially long-term bonds whose interest rates have remained low in the past year. These long-term yields have strongly correlated with monetary policy expectations. Since the outlook for interest rates increases that are discounted for next year are moderate, a readjustment of such yields could boost returns on the long end of the yield curve to levels of 5.5% at the end of 2005.

### A somewhat more abrupt adjustment of the financial variables cannot be ruled out

It should be pointed out that there are elements of uncertainty especially linked to a greater depreciation of the dollar associated with a sudden adjustment in the U.S. current account deficit. Given the important role played by the central banks in financing this deficit (compared to that of direct investment in the 1990s), less active intervention by Asian central banks or a change in the composition of their assets in terms of foreign currencies, with less preference for assets in dollars, would lead to a scenario of an abrupt adjustment of the greenback, in which dollar-euro parity could reach levels of 1.4. Exceeding this range would imply a greater risk of inflation and would push the Fed to more aggressively up their interest rates until reaching 5% at the end of the year. In this scenario, the demand for a higher risk premium could also lead to increasing long-term interest rates to levels of 6.5% at the end of 2005.

### U.S.: Fed Funds Rate

%




Source: Federal Reserve and BBVA

### U.S.: Interest Rates

Source: BBVA with Bloomberg data

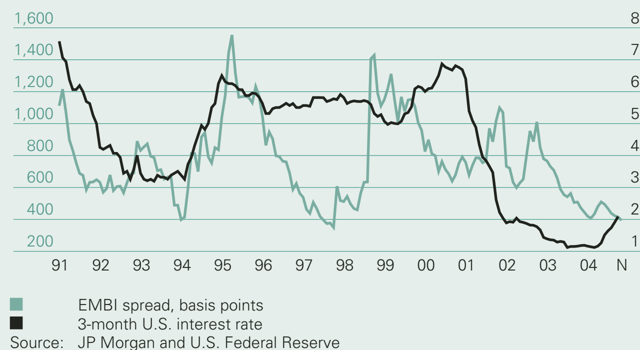
# Emerging Market Spreads and Liquidity

## Is there an overreaction of emerging market spreads to international liquidity?

In the second half of 2003 sovereign debt spreads in emerging markets fell rapidly. In 2004 they stabilized at levels comparable to those prior to the Southeast Asian crisis.

Many analysts feel that the current scenario has been caused by the expansive monetary policy of the U.S. Federal Reserve. This diagnosis is based on the high correlation observed between interest rates in the U.S. and the spread in emerging market bonds. From July 2002 to May 2004, the correlation between the three-month rate in the United States and the EMBI was 0.91.

### Spreads and U.S. Interest Rates




EMBI spread, basis points
3-month U.S. interest rate
Source: JP Morgan and U.S. Federal Reserve

## 2004 vs. 1994: A return to the past?

This correlation has sparked apprehension among many analysts who recall the developments that occurred in 1994, when high liquidity led to restrictive monetary policies on the part of the Fed, with interest rates increasing from 3% to 6% in 12 months. This increase boosted the price tag of the rollover of the Mexican debt and sparked what was known as the "Tequila effect."

But what is the trend in this correlation when viewed over a longer period of time? If we consider the correlation starting from 1994 it can be noted that it is not significant and in some periods is in fact negative (-0.26), such as in the three years between 1999 and 2001 in which it was -0.41. In the past six months, that is, between May and November 2004, we see a negative correlation in which U.S. rates have been increasing while emerging bond spreads have decreased.

## What can we expect in the next few months?

Considering the results of a vector autoregressive analysis, a possible end to such shocks will lead to the spread once again increasing from -3.28 to -2.83 (equivalent to a 250 basis-point rise) at the end of 2005.

There are many other factors that are necessary to control econometrically in order to be able to predict future spreads. The projections are difficult to make over time, especially if they are medium- and long-term forecasts. In any event, the current situation in relation to reserves and the debt structure in emerging markets ratifies this result, in the sense that the projected increase in the spread would not assume catastrophic levels, as was the case in 1994.

Macroeconomic fundamentals are better than in 1994 and the transmission channels are not as sensitive. The first channel in which an increase in U.S. rates affects the spread in emerging markets involves a substitution effect, inasmuch as it is more attractive to acquire U.S. bonds as opposed to those offered by the emerging markets. This shift in demand translates into a lower price for emerging market bonds and therefore, in a possible increase in their spread.

The second effect is in relation to the supply of emerging market bonds. With an increase in U.S. rates, and with the resulting demand for dollars, the U.S. currency appreciates. The dollar appreciation leads to an increased likelihood of default on the emerging market debt (especially in Latin America, since the sovereign debt is mainly denominated in dollars) and, as a result, a rise in the risk premium for such paper.

But the elasticity currently displayed by these spreads is different from the 1994 experience. This is because one of the lessons learned in the 1990s was the need to maintain higher reserves, deepen the trade opening, and improve the foreign debt structure, mainly by extending its maturity. Therefore it can be expected that, if the upward cycle of U.S. interest rates continues, the emerging bond spread in Latin American countries will increase, albeit not traumatically, as was the case in 1994, but rather moderately, which would not generate adverse effects.

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# Oil Market

## Oil prices to be adjusted 26% in the next two years

At the close of November 2004, oil prices accumulated a 54% increase with 16.5% volatility. Since the close of 2001, they have increased 155%, with an average price of US$30 per barrel and 22% volatility. In light of this behavior, three questions should be posed: What has changed in the oil market? Why has the impact of this rise in oil prices been less than in the past? How will prices evolve in the next two years?

Structural changes have taken place in the oil market in the past five years that explain the current behavior of oil prices. About 75% of the average increase in daily demand in this period is associated with emerging economies headed by China and the rest of the Asian nations, which are characterized as being 2.5 times more inefficient in the use of oil per percentage point of GDP than the OECD member countries. In terms of supply, 60% of the average daily increase in crude oil production corresponds to the countries that had been part of the former Soviet Union, led by Russia, while the OPEC member states have contributed only 20% of the growth in output. In addition, the OPEC's additional production capacity, which represented 15% of the world demand for crude oil in 1989, currently accounts for 2%. Behind this reduced elasticity in supply is the decrease in real terms in investment in exploration and production, which fell 16% on average for the 1983-2003 period compared to levels posted in 1973-1982, while production increased in the same period by 13%. With these structural changes, the "fair value" for Brent crude oil is US$30-US$32 per barrel in real 2004 dollar terms.

## The impact of the increase has been limited

In evaluating the average Brent price for 2004, which was US$38 per barrel, it should be noted that in real terms it represents only half the average for the 1974-1984 period. If it is compared with the previously sustained price increases registered in 2000, which lasted 20 months, the current rise measured in real terms represents only 60% growth in average prices for the United States and 44% for Europe.

In the short term, the productivity shocks have meant that the impact of the rise in oil prices, lessened in real terms, has not been devastating to growth. The sustained impact of higher oil prices has a greater repercussion on inflation than on growth. In the United States, a sustained increase of US$10 in oil prices for more than one year leads to a 0.2% decline in economic activity and a 40 basis-point rise in inflation, while for Europe the corresponding impact is 0.4% and 50 basis points, and for Japan, 0.3% and 50 basis points.

## Oil prices projected to fall US$11 between 2004-2006

In the short term, there is a disalignment of market prices with regard to "structural" prices, expressed in a risk premium of about US$14 due to temporary circumstances. This is the result of both demand and supply considerations that will not be operative in the next two years.

On the supply side, there is a nine-dollar premium that will be reduced as Saudi Arabia boosts its production, Iraq stabilizes its output at between 2.0 million to 2.4 million barrels daily, and the Yukos' fiscal difficulties are resolved. In terms of demand, to the extent that there are no new surprises, prices will be reduced by about 5 dollars, which are currently having an impact on the market in the short term. In fact, it is expected that facing the coming year, world demand, after experiencing 3.5% growth in 2004, will expand 2% in 2005. The increase in demand in the developed countries is estimated to be around 1.4%. Supply will post a similar increase to demand, so that stability in the current inventory stock is expected.

### Oil Scenario 2004-2006
**US dollars per barrel, average**

| | WTI | Brent | | WTI | Brent |
|---|---|---|---|---|---|
| I 2003 | 33.9 | 31.3 | I 2005 | **44.7** | **40.3** |
| II | 30.0 | 27.0 | II | **40.6** | **37.8** |
| III | 31.0 | 28.6 | III | **39.0** | **36.3** |
| IV | 29.9 | 28.5 | IV | **37.4** | **34.8** |
| I 2004 | 35.2 | 31.8 | I 2006 | **35.9** | **31.4** |
| II | 38.4 | 35.5 | II | **35.5** | **32.0** |
| III | 44.1 | 41.7 | III | **34.9** | **32.4** |
| IV | **48.8** | **42.7** | IV | **34.1** | **31.7** |

Source: BBVA Banco Provincial

For 2005, the estimated average price per barrel for the Brent is US$37.3, while for 2006 the projected average will be US$32, representing an 8.7% adjustment between the close of 2005 and the end of 2006. For the next two years, an accumulated adjustment of US$11 dollars is expected, equivalent to 26% of the price level at the close of 2004.

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