International Environment

The extreme volatility of the markets can be attributed to the persistence of liquidity tensions and the global financial and economic uncertainty

A few months ago, to speak of the international financial crisis was synonymous with relating the sequence of developments that occurred in the U.S. market. But since September 12, 2008—the date when Lehman Brothers crashed—an inflection point has occurred on a world level. The uncertainty and investors' strong aversion have spread to all regions of the globe, especially Europe, but also to the emerging markets.

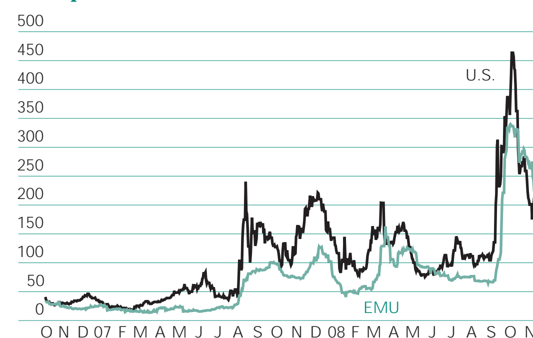
Following the collapse of Lehman Brothers, the problems of the financial sector have intensified, and the U.S. government approved the Troubled Asset Relief Program (TARP) —also known as the Paulson Plan— with the aim of reducing the problem of the toxic assets in bank balance sheets and thus alleviating the problems of liquidity and solvency of many U.S. financial institutions, even though the program has involved, for the time being, the injection of public capital into the banks. Contrary to what occurred in the episodes involving Bear Stearns, AIG, or government agencies, the Lehman Brothers collapse involved considerable losses for bondholders, together with the perception that there were no large banks in the United States that could go bankrupt, a development that significantly intensified the tensions in the markets. This strong increase in interest rate spreads caused liquidity to reach unsustainable (and never before seen) expensive levels. For example, the spread between the libor rate minus that of the 3 month overnight index swap (OIS) —which approximates the availability of funds in the markets —of the United States is currently at 180 bp (366 bp maximum), while in the European Monetary Union (EMU) it is at 165 bp (194 bp maximum.). At the same time that the financial tensions were intensifying, the bank crisis not only in the United States but also in other European countries worsened and risk aversion became a global phenomenon.

The stock markets on a global level have posted historic drops. Thus far in 2008, the losses in the main stock markets of the developed countries are around 40%. The range of the declines in the emerging markets is greater, and extends from 17.0% in Chile to 76.0% in Russia. In addition, the aversion levels are extreme. This high risk aversion, together with the fall in monetary policy expectations, explains the average 60 basis-point decline in October on yields for the 2-year U.S. Treasury note and the 100 basis-point fall in the European Monetary Union, which has taken place since the Lehman Brothers crash. The search for a safe haven is underway.

Following the first unilateral attempts, the main developed countries are unifying criteria to face the global crisis

The central banks have injected enormous amounts of liquidity into the market with the aim of alleviating the financial tensions, but thus far the measures adopted have not had a healing effect that would permanently stabilize them. The Federal Reserve has increased the

Liquidity Tension Indicator: Spread between U.S. Treasury bills - 3 month Euribor
Basis points



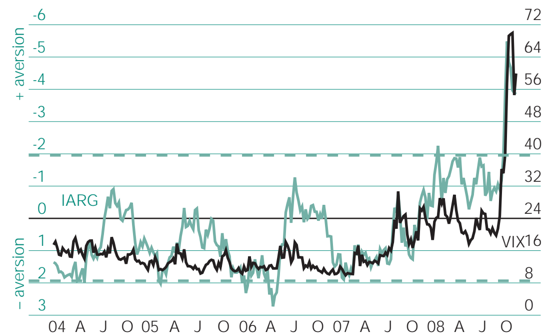
Source: BBVA Bancomer with Bloomberg data

Interbank Liquidity Tension Indicator: Spread between Libor - 3 month OIS
Basis points

Source: BBVA Bancomer with Bloomberg data

Global Risk Aversion Index (BBVA-IARG)

64 assets: emerging (US$) and developed markets (local currency)



Source: BBVA Bancomer with Datastream data

Stock Markets

Accumulated % change in the year

		2008
United States	S&P500	-46%
Spain	IBEX35	-47%
United Kingdom	FTSE100	-38%
France	CAC40	-47%
Germany	DAX30	-48%
EMU	STOXX	-50%
Japan	NIKKEI 225	-50%
China	Shanghai SE 180	-64%
Hong Kong	HANG SENG	-56%
Brazil	BOVESPA	-48%
Mexico	MXSE IPC Gral.	-38%
Argentina	MERVAL 25	-59%
Chile	SASE Gral Index	-17%
Russia	IRTS	-76%

Source: BBVA Bancomer with Bloomberg data

risk in its balance sheet, drastically reducing its bond holdings and Treasury notes and focusing on providing greater credit facilities to the system (financial entities, semi-public mortgage companies, insurance companies, mutual funds, etc.) and more than US$500 billion in swap lines to facilitate dollars to other central banks. This has been, to a large extent, financed by Treasury bond issues deposited in its balance. Its latest measures, at the close of this report, are very aggressive, with US$600 billion earmarked to purchase debt and mortgage instruments of semi-public companies and US$200 billion to acquire securities backed by new loans to students, consumers, and businesses. The European Central Bank (ECB) has also held auctions that are extraordinary in terms of the amounts placed, currencies and terms. The latest initiative of the ECB has been to begin holding full allotment auctions, with the aim of alleviating the pressures on short-term financing needs. However, compared to the measures adopted by the U.S. government, they have proven to be less proactive.

The economic and monetary authorities of the different countries face a financial crisis that is expanding due to the effect of risk aversion and they are rapidly taking measures to deal with it. In an initial phase, the different governments undertook measures aimed at restoring confidence among the depositors of financial institutions and guaranteeing normality in the financial markets, with a limited effect. The main reason is that the markets were characterized by a complete lack of coordination among the governments and that the steps taken were perceived as specific responses as concrete problems arose in different institutions, agencies, and companies.

At the beginning of October, however, coordinated actions began to emerge. First of all, the central banks of the United States, the European Monetary Union, the United Kingdom, Switzerland, Sweden, and Canada simultaneously and via a common communiqué reduced their official interest rates by 50 bp. Shortly thereafter, the European governments reached a timely agreement to face the crisis in a coordinated and consensus-based manner, in which programs were announced based on guarantees and capital injections. Although the immediate impact has been limited, this coordination probably prevented an even more serious financial crisis.

These efforts culminated in the G-20 summit held in Washington, D.C. The first point that should be emphasized concerning the summit, and the agreements adopted, is that it reflects the firm intent of the international community to face the current economic and financial crisis in a coordinated fashion, combining multilateral measures and actions with policies that are national in scope but agreed upon and validated by all the participants in the summit. This is very important, since it allows for avoiding errors committed in the past when strictly national responses, at times purely protective, only served to increase the recessive aspects of the crises. Also important is the announced list of measures, which is ambitious and is based on an adjusted diagnosis of the causes of the crisis and its subsequent extension and intensification, with additional fiscal support measures to come.

Growth, inflation, and low interest rates, an appreciated dollar

Considering that the tensions in the international financial markets will not subside in the short term, and given that the global financial context will possibly evolve in a situation in which there is less credit available for families and companies, our projection for the United States and the EMU reflects an intensification of the economic downturn. In terms of our scenario for U.S. economic growth, we expect that consumption, housing and non-housing investment will continue contracting, and therefore, will be contributing negatively to growth. Moreover, with regard to foreign trade, although imports will continue to fall, exports will grow at a slower rhythm due to the global weakness and the appreciation of the dollar. In conclusion, we expect U.S. GDP to contract 0.8% in 2009 but it could grow around 1% in 2010. For the EMU, we expect a contraction of GDP of around 0.9% and a recovery toward zero growth in 2010. Even though there are some factors that are partially positive, such as substantially lower official interest rates and the euro depreciating in relation to the dollar, the effectiveness of the packages of measures designed by the different governments will be key in preventing a greater contraction of economic activity. Nevertheless, if the fiscal support packages currently under discussion are successful, economic growth in the EMU and the United States will become positive as of 2009.

With regard to inflation, we anticipate that it will continue heading toward levels substantially below the current numbers. Our scenario for 2009 considers that headline inflation in the United States will be around 0.8% on average. In the EMU inflation will clearly be below 2% on average. Such expectations are justified by the recent significant drop in oil prices and in those of other raw materials, coupled with a scenario of lower global growth. The fact that inflation is being contained will allow for new declines in interest rates. Our scenario for official interest rates indicates that the Fed will cut its intervention rate to as low as 0.5% and the ECB will set it at 1.5% at the beginning of 2009. Thus, we expect a stable dollar, fluctuating at a level of around 1.25 to the euro until the end of 2008. For 2009, we project that the dollar-euro exchange rate will slide toward 1.15, although we would note that the risks are tending toward the side of a possible greater appreciation of the dollar.

For the EMU we expect yields on 10 year bonds to close 2008 at 3.80%. During the first quarter of 2009, yields should fall to 3.50%, declining as the year progress until reaching 3.10% in the fourth quarter of 2009. In our central scenario for official rates, we expect the yield on the 10-year U.S. sovereign bond to remain stable at 3.80% through the close of the fourth quarter of 2008. For 2009, we foresee a drop in yields, with these beginning 2009 at around 3.70% and ending the year at 3.40%.

In view of the challenges of the next few months, the evolution of the policies that the governments develop —focused on restoring financial stability and a better operation of the markets— will be a crucial element in order to recover confidence, break the vicious circle between liquidity and solvency, and thus reestablish the normal functioning of the markets.

United States Indicators and Forecasts

	2007	2008	2009	I'08	II'08	III'08	IV'08	I'09	II'09	III'09	IV'09
Economic Activity											
GDP (real annual % change)	2.0	1.4	-0.8	2.5	2.1	0.8	0.2	-0.5	-1.4	-1.2	-0.3
Personal consumption expenditures	2.8	0.2	-2.5	1.5	1.3	0.0	-1.8	-2.6	-3.3	-2.7	-1.3
Gross fixed investment	-3.1	-3.2	-2.2	-2.5	-3.6	-4.8	-1.9	-1.6	-2.2	-1.6	-3.4
Non-residential	4.9	3.2	-2.5	6.2	4.2	1.8	0.6	-1.0	-2.6	-3.2	-3.4
Residential	-17.9	-21.0	-10.3	-21.3	-21.6	-21.3	-19.7	-15.0	-13.1	-8.8	-3.4
Total exports	8.4	8.4	2.0	10.1	11.0	6.9	5.9	4.8	2.0	0.7	0.6
Total imports	2.2	-2.3	-3.1	-1.0	-1.9	-3.1	-3.1	-3.7	-2.6	-3.0	-3.2
Government consumption	2.1	3.0	3.2	2.6	2.6	3.1	3.6	3.8	3.5	2.8	2.8
Contribution to Growth (pp)											
Personal consumption expenditures	2.0	0.2	-1.7	1.0	0.9	0.0	-1.3	-1.9	-2.3	-1.9	-0.9
Private investment	-0.9	-0.7	-0.3	-0.4	-1.1	-1.2	-0.3	-0.4	-0.1	-0.1	-0.5
Net exports	0.6	1.4	0.8	1.4	1.7	1.4	1.3	1.2	0.7	0.6	0.6
Government consumption	0.4	0.5	0.6	0.5	0.5	0.5	0.6	0.7	0.6	0.5	0.5
Prices and Costs (annual % change, average)											
CPI	2.9	4.2	0.8	4.1	4.4	5.3	2.8	1.8	0.8	-0.5	1.0
Core	2.3	2.3	1.2	2.4	2.3	2.5	2.0	1.5	1.3	0.8	1.1
PCE	2.6	3.6	1.1	3.5	3.7	4.4	2.7	2.0	1.2	0.2	1.0
Core	2.2	2.2	1.4	2.2	2.3	2.5	2.0	1.7	1.5	1.1	1.2
GDP deflactor	2.7	2.4	1.4	2.3	2.0	2.7	2.5	2.1	1.5	0.7	1.3
Productivity	1.4	2.5	0.9	3.3	3.2	2.0	1.3	0.8	0.0	0.8	2.0
Real compensation per hour	1.2	-0.6	0.4	-0.8	-0.2	-0.8	-0.6	-0.6	0.2	1.2	0.9
Unit labor cost	2.7	1.0	0.3	0.0	0.7	2.3	0.9	0.4	1.0	-0.1	-0.2
Other Indicators											
Industrial production (real annual % change)	1.7	-0.8	-2.9	1.9	0.2	-2.6	-2.4	-2.9	-2.9	-3.3	-2.4
Capacity utilization (%)	81.0	78.6	74.7	80.6	79.7	77.9	76.2	75.6	75.0	74.4	73.8
Light weight vehicle sales (millions, annualized)	16.2	13.3	11.9	15.2	14.1	12.9	11.0	10.6	11.5	12.4	13.3
Housing starts (thousands, annualized)	1,341	934	741	1,053	1,025	877	781	751	722	731	760
Nonfarm payrolls (thousands of new jobs, average)	91	-141	-288	-82	-71	-159	-250	-282	-312	-304	-256
Unemployment rate (average, %)	4.6	5.7	8.2	4.9	5.3	6.0	6.7	7.9	8.3	8.4	8.3
Personal savings rate	-0.2	0.0	0.0	-0.3	-0.2	0.1	0.4	-0.1	0.1	0.6	1.0
Trade balance (US$ billions)	-700	-680	-582	-177	-181	-177	-146	-144	-161	-157	-121
Current account balance (US$ billions)	-730	-688	-600	-704	-734	-704	-611	-600	-670	-626	-506
% of GDP	-5.3	-4.8	-4.2	-5.0	-5.1	-4.9	-4.2	-4.2	-4.7	-4.4	-3.5
Fiscal balance (US$ billions, fiscal year)	-163	-607	-938	—	—	—	—	—	—	—	—
% of GDP	-1.2	-4.2	-6.5	—	—	—	—	—	—	—	—
Financial Markets (eop)											
Fed Funds (%)	4.25	0.50	0.50	2.25	2.00	2.00	0.50	0.50	0.50	0.50	0.50

eop end of period
CPI Consumer price index
PCE Personal consumption expenditures index