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# Economic Outlook

## Global

May 2011
Economic Analysis

- **The global economy continues growing strongly,** propelled by emerging economies.
- **Oil prices will remain elevated in 2011,** but the effect on global growth can be absorbed.
- **Pressure on inflation from commodity prices brings forward monetary tightening globally,** though among developed economies at different paces in US and Europe.
- **Lack of decisive action from policymakers in EMU** and related solvency concerns will keep market tensions elevated in the euro area.
- **Overheating concerns continue in emerging economies,** but going forward, they may become a bit more acute in South America, given tailwinds from commodity prices.

# Index



Closing date: May 10, 2011

# 1. Summary: recovery, global shocks and vulnerabilities

## The global economy will continue growing strongly, but risks are tilted to the downside

The global economy continues to grow at a robust pace, and is still expected to expand 4.4% both in 2011 and 2012, supported primarily by emerging economies (Chart 1). However, the threat coming from high commodity prices (especially oil) increases the uncertainty and introduces a risk to growth and inflation in most regions, even to some of those that might benefit directly from high commodity export prices. At the same time as this global shock develops, local risks identified in the previous issue of the Global Economic Outlook continue more or less unchanged. Financial stress in Europe is likely to continue, especially for Greece, Portugal and Ireland. The political noise around proposals to finally start the process of fiscal consolidation in the US will only add to uncertainty in the markets, even as we think that some form of fiscal adjustment will take place in the end. Finally, overheating pressures in emerging markets continue, although going forward probably they will be more of a concern in South America, given tailwinds from commodity prices.

## High oil and other commodity prices represent a global risk but should be readily absorbed without denting much global growth

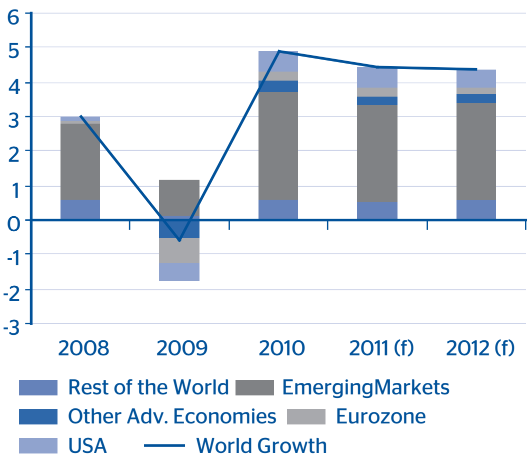
The greatest global risk stems from the rise in oil prices, caused, since the beginning of the year, mostly by political instability in the Middle East and North Africa (MENA). Although uncertainty is high and protests in the region are still unfolding, in our view, contagion to the point of disrupting oil production in other important oil producers beyond Libya will not occur. Thus, the geopolitical risk premia incorporated in oil prices will slowly but gradually be reduced, given still ample OPEC spare production capacity and OECD inventories, both above historical means. Nonetheless, oil prices would remain high at around 110-120 dollars per barrel during most of 2011, to slowly flex down to around 100 dollars in 2012.

In this context, in which the price of other commodities such as food and metals has also increased, the main (negatively) affected regions will be the major developed countries and most of emerging Asia, the main importers of raw materials. On the other hand, the main beneficiaries of improved terms of trade would be the Middle East and Latin America, which will recycle part of this windfall revenue. However, a shock of this magnitude will be absorbed by the global economy without significantly affecting economic activity. This, together with relatively strong data in the first quarter of 2011, justifies relatively unchanged growth forecasts in most areas, as compared to our February Global Economic Outlook. The main exception is Mexico and South America, where strong data in the first three months of 2011 and better terms of trade imply a moderate upward revision of our growth forecasts for 2011. Europe will continue to grow mostly in core countries rather than the periphery, while risks to the U.S. growth forecast shift from being biased upwards three months ago to be more balanced by higher oil prices.

## High oil prices will push up headline inflation, bringing forward expected central bank interest rate increases in most areas

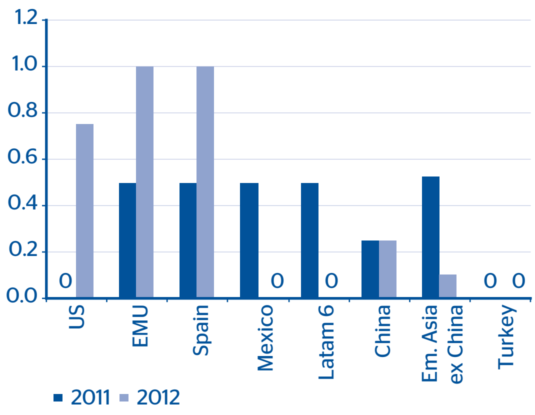
The main effect of the oil shock will be felt on prices. Higher inflation in most economies in 2011 and 2012 will prompt monetary authorities to bring forward and in some cases push for more aggressive paths of interest rate increases (Chart 2). Nevertheless, there is still a wide heterogeneity in central bank approaches to the risks stemming from high oil and other commodity prices. In particular, in the US and euro zone, central banks are shifting –at different degrees– their focus from supporting growth or preventing a tail risk scenario of very low growth and deflation, toward maintaining inflation expectations anchored, particularly considering that the monetary policy stance is very accommodative. As a consequence, the balance of risks has tilted towards a higher probability of earlier hikes. The timing of the first hike depends on the perceived need to react to potential risks of second-round effects. The ECB hawkish approach is to avoid any risk by being pre-emptive (and thus its first hike in April), and is not willing to look through the current oil price related rise in inflation. On the other hand, the Fed, focusing more on the lack of sustainability in the recovery, prefers to wait and act only if risks materialise. Between these two approaches, emerging economies seem open to more front-loaded hikes if needed, but with an eye also on not excessively encouraging capital inflows and exchange rate appreciation.

Chart 1
Global GDP growth and contributions (%)




Source: BBVA Research and IMF

Chart 2
Changes in year-end expected official interest rates relative to February 2011 forecasts




Source: BBVA Research

## Financial tensions in peripheral Europe will remain high given lack of decisive action to deal with solvency concerns

In Europe the agreements reached during the March summits are useful for the medium term both in terms of economic reforms and to help prevent future crisis. In addition, the changes introduced to the EFSF/ESM are positive to address liquidity concerns. However, financial market tensions in the three peripheral countries with international support (Greece, Ireland and Portugal) will continue as long as doubts persist about the solvency of some countries and thus the risk of debt restructurings that include private investors. These lingering doubts will continue hindering the funding to these economies and sustaining high sovereign spreads and could spread to other countries, even those with high solvency credentials. Thus, a comprehensive approach to debt resolution in case of insolvency is urgently needed, but one that takes into account that undergoing a hard debt restructuring that includes haircuts to private investors has a very high risk of contagion to the rest of Europe, so it will have to be designed carefully.

For its part, Spain has been able to differentiate itself from these three peripheral countries given advances in fiscal consolidation and economic reform including, in particular, those aimed at the financial sector and the labour market. However, continued decoupling and a meaningful reduction in spreads will depend crucially on the satisfactory completion of the recapitalization of the financial system –with a prompt entry of private capital–, on continued fulfilment of fiscal consolidation targets –including in the regional governments– and continuing advancing reforms, especially in the labour market.

## In the US, fiscal consolidation will likely be achieved, but after a protracted period of elevated political noise

In the U.S., the political process to reach a sustainable path for public debt involves difficult negotiations between two opposite approaches to deficit reduction. In the end, fiscal consolidation will have to come either from a reduction of entitlements or from higher tax revenues. In our opinion, both parties will reach an agreement that translates into lower deficits and a sustainable debt path, but the political noise until that agreement in reached will only add more uncertainty into the markets, especially as the discussion on the debt ceiling brings opportunities to harden the negotiations.

## Overheating concerns continue in emerging economies, but going forward, they may become more acute in South America, given tailwinds from commodity prices

Emerging economies continue to show risks of overheating, but with marked heterogeneity. Some countries are beginning to confront these risks through more restrictive monetary policy and, in some cases, also fiscal tightening, for example, in the important cases of China and Brazil. We think overheating risks are manageable but, going forward, they will become more pronounced in South America, to the extent that a commodity price increase represents a tailwind for South America but cooling headwinds for emerging Asia. In addition, doubts about the true extent of the slowdown in Japan could slow down economic activity in most of Asia, given extensive trade links and integrated production chains. Furthermore, current account surpluses in much of Asia are a more comfortable buffer for countries in the region, as compared to South America.

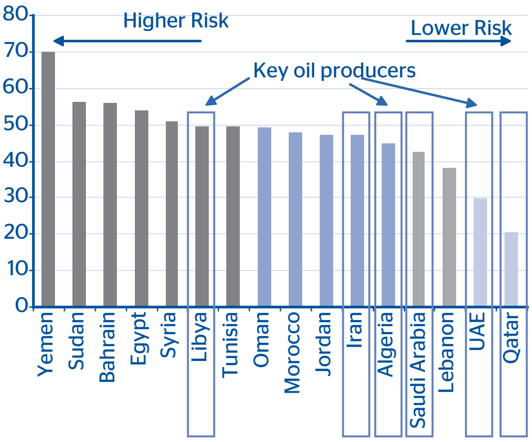
# 2. Global fallout from commodity price shock

## Political instability in the Middle East and North Africa (MENA) can be traced to political, economic and demographic factors that are hard to replicate in other regions

Although the wave of social tension that erupted throughout MENA last December took the community of regional analysts by surprise, there is a fairly unanimous consensus on its causal factors. By and large, there are a set of socio-economic and political factors that are common to most countries in the region, and that have acted as a powerful catalyst for revolt. In the political dimension, the most important is the existence of an autocratic government, usually in power for a large number of years, which significantly represses civil liberties. These are often complemented by a set of economic circumstances, in the form of low living standards, high unemployment (particularly among the youth), or widespread corruption. Finally, a high percentage of young population and a disenfranchised community have been additional elements that contributed to unrest.

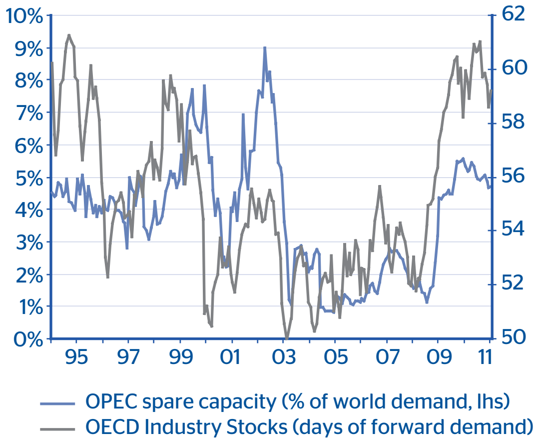
To counter this, some governments have been able to channel public funds to appease the opposition. This is particularly the case of some oil exporters like Saudi Arabia where the government responded to the first signs of domestic unrest with a generous 35 bn dollar package of social expenditures. Countries without the blessing of oil funds, understandably, have tended to make political compromises, when making any at all. In this way, therefore, the size of public funds available is another relevant piece of information to define the political game currently at play in the region.

Chart 3
**BBVA Index potential unrest in MENA countries**




Source: BBVA Research

Chart 4
**Oil market buffers**




Source: BBVA Research and Haver Analytics

The previous considerations are far from being an exhaustive list of the determinants for anti-government mobilization in MENA countries. Yet, they are a concise and quantifiable set of indicators that allow for assessing the relative vulnerability of countries to this type of revolt. Indeed, Chart 3 summarizes this information on an index of risk of uprising in MENA countries. The index weighs economic variables (GDP per capita PPP, unemployment rate), governance indicators (voice and accountability, control of corruption, the number of years of autocratic rule), the percentage of the population under 25 years old, and the ability of the government to "bribe" society through social transfers (reserves as % GDP). Finally, it also includes the presence of religious disenfranchisement, and the percentage of the population that belongs to the disempowered community. The weights assigned are relatively balanced between the three types of variables (political, economic, and social). The resulting index relates higher scores with a higher likelihood of unrest.

Interestingly, the resulting index in Chart 3 does a relatively good job in identifying the countries more prone to turmoil. Among the countries with the highest index value (i.e., the riskiest) we find the two where activists have been able to overthrow the government (Egypt and Tunisia), and those where confrontation is or has been at some point more intense (Libya, Bahrain, Yemen, Syria and also Sudan in the past). In a similar fashion, countries with middle index values (i.e., Oman to Algeria) are largely characterized by a significant degree of tension, but far below the high index countries. Finally, in the low index countries (i.e., Saudi Arabia to Qatar) anti-government demonstrations have been virtually negligible.

An important point to note in Chart 3 is that, except for Libya, the most important oil producers in the region show medium to low chances of unrest. Countries like Iran or Algeria are two other relevant energy exporters in the region, with risk index levels in the medium range. Saudi Arabia on the other hand, while being the most important global energy provider, shows lower risk levels.

All in all, there are wide differences among MENA countries with respect to the risk of social tensions. If we add the idiosyncratic factors that have so far affected the course of events in each country, we can hardly state that there is a uniform move towards greater social mobilization, much less democratization. Four months into the crisis, the regional picture that emerges differentiates between countries that are making slow and still uncertain progress towards a meaningful regime change, and others where democratization prospects are heavily constrained by a swift state response, negligible citizen participation, or both. Currently the most promising grounds for democratization are found in Tunisia and Egypt. The degree of social tension has been reduced. Thus, there is some progress towards dismantling the apparatus of the former regime, while at the same time setting the foundations for a transition process (the creation of interim government, legalization of formerly banned political parties, etc.). Libya, of course is one of the most conflictive spots, where conflict escalation has virtually eliminated the chances for a negotiated solution. In Bahrain, the prospects for a peaceful –or any- political change are also severely dampened, particularly after the government declared the state of emergency and called on other GCC members to help with cracking down the opposition.

The rest of the region is characterized by a much lower degree of social mobilization, which is being counterbalanced by a varied mix of “carrots and sticks”. Iran and Syria are at one extreme, clearly favouring repression over concessions. In contrast, GCC oil exporters largely opt for economic concessions, especially in the case of Saudi Arabia. Here, however, we cannot disregard the potential recourse to force if dissent becomes more vocal. Finally, countries with a more delicate fiscal position (Morocco, Jordan and Algeria to a lesser extent) have made more meaningful political commitments.

Will the Jasmine revolution spread to other geopolitically important regions? This is very unlikely in our view. Some of the factors highlighted above as the main determinants of unrest in MENA countries can be found in China, Russia or Turkey, but it is very difficult to find a combination of all these factors in one place. In the case of China and Russia, for example, low levels of youth unemployment and the ability of both economies to mobilize fiscal funds for social transfers will go a long way to defuse any threat of revolt. In the case of Turkey, turmoil is unlikely to extend there given its completely different economic, political and institutional background, as the country is a role model for the region given its democratic institutions, free-speech rights and a secular, moderate government. Moreover, in all three cases, high growth rates that seem to benefit wide sectors of the population are an important differential factor with respect to MENA countries, especially oil-importing ones.

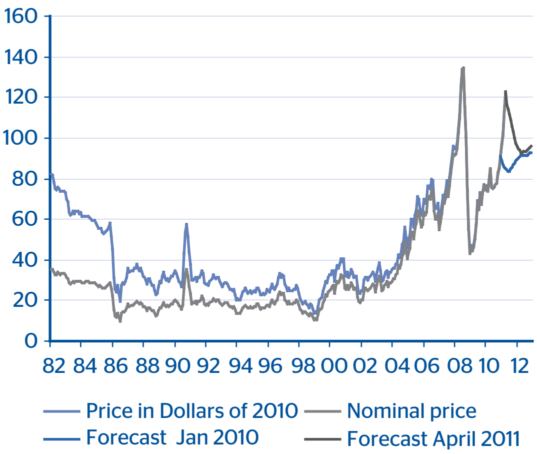
## Oil and other commodity prices will remain elevated during 2011, but they should flex down slowly as contagion to other important oil producers in the region is prevented

In this context of turmoil in one of the key oil producing regions, oil prices continued their upward trend, beyond 120 dollars per barrel during April. This was motivated in part by the loss of Libyan production and continued violence in the region, which added a significant geopolitical risk premia to oil prices. In addition, continued strong demand from North America and Asia –which does not seem to have been affected much by higher oil prices– and dollar weakness also played a role in surging prices in nominal terms.

Despite the loss of Libyan output and still strong demand, OPEC was able to cover most of the shortfall by increased production, especially from Saudi Arabia. Although it is hard to entirely substitute high quality oil coming from North Africa, spare capacity in the oil cartel before the conflict started was well above the average of the last five years (Chart 4), and surely much higher than at the previous oil price peak in 2008 (Chart 5). This buffer, together with high OECD stocks –also higher than the average of the last 5 years (Chart 4)– seems to have moderated the market response to the loss of Libyan production (around 2.6% of global oil demand), so that oil prices have stabilized at around 120 dollars per barrel for the time being.

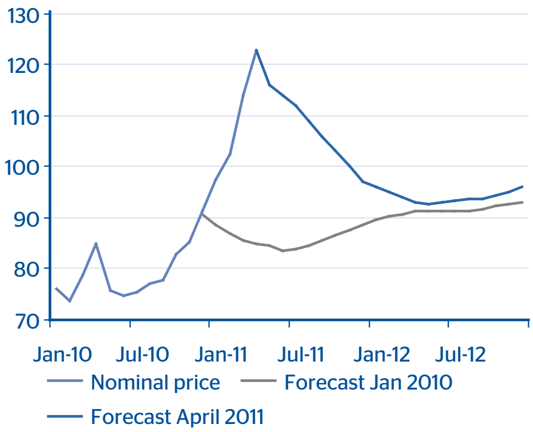
Going forward, we see a very low probability of contagion of unrest to other key oil producers in the region (Algeria and the Gulf countries) and we expect the geopolitical risk attached to oil prices to die down gradually, albeit slowly. Thus, we expect oil prices to remain high during much of 2011, at around 120 dollars per barrel, gradually easing towards 100 in 2012, more in line with supply and demand fundamentals, as reflected in our oil prices forecast three months ago (Charts 5 and 6).

Chart 5
Oil prices in nominal and real terms (USD/ barrel)



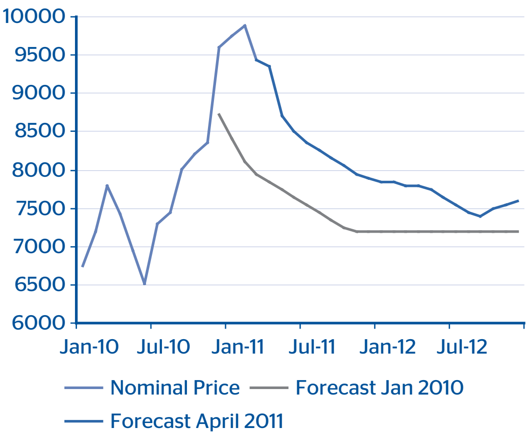

Source: BBVA Research and Haver Analytics

Chart 6
Oil prices (detail, USD/ barrel)



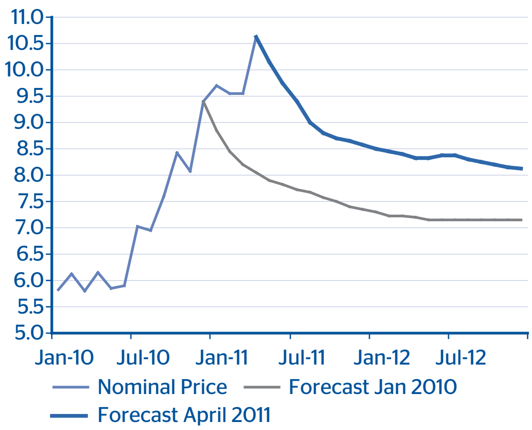

Source: BBVA Research and Haver Analytics

Chart 7
Copper prices (USD/ton)




Source: BBVA Research and Haver Analytics

Chart 8
Food prices (index)




Source: BBVA Research and Haver Analytics

Although less dramatic than the rise in oil prices, other commodity prices have also seen unexpected increases in the last three months since our previous Global Economic Outlook, but normalization of supply and moderation of demand should point to easing prices going forward. Indeed, metal prices rallied strongly in the first quarter of 2011, driven largely by the strong recovery in emerging economies, although some weather-related supply disruptions also played a role. The slow supply response to higher demand meant that inventory buffers were declining, although, going forward, expected growth deceleration in emerging economies should moderate global demand for metals and contribute to easing prices (Chart 7).

Food prices have increased by around 12% on average since February due to reduced inventories and a tight supply/demand ratio. Going forward, unrest in MENA countries could also put additional pressure if governments step up their purchases of grains to ensure supply in those heavily subsidized markets. Nevertheless, the return of normal weather conditions should translate into better harvests than last year and thus increased output and lower food prices (Chart 8).

Given the uncertainty surrounding the geopolitical situation in MENA countries, uncertainty around the forecast for commodity prices is very high. In the case of oil, there is a small but relevant probability that unrest might spill to other key producer. Although there should be enough spare capacity in OPEC to cover that lost production, the resulting reduced buffer and the possibility of a chain reaction in the region is likely to push oil prices to the highs reached in 2008 (around 140 dollars per barrel) and keep them for a considerable time. In this scenario, metal prices would surely suffer from the ensuing blow to global growth, and food prices would also be negatively affected, except those benefiting from higher demand for biofuel production (e.g. corn).

## The effect of higher commodity prices on activity will be heterogeneous by regions, but overall, the global economy will be able to absorb it without much impact on growth

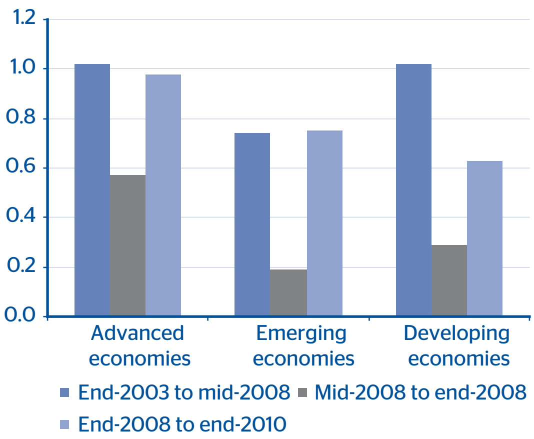
Under this scenario of higher commodity prices there will be an increase in net income transfers from commodity importers to exporters. In particular, the US, Europe, Japan and most of emerging Asia will have to transfer an additional 500 bn dollars in 2011 (as compared to 2010) to commodity exporters (especially the Middle East and, to a lesser extent, Latin America). Quantitatively, it would imply approximately 1% of GDP being transferred from developed economies (G3) and East Asia to commodity exporters (for further details, see Box 1).

However, a shock of this magnitude will be absorbed by the global economy without significantly affecting economic activity. An exercise quantifying such effect for both the U.S. economy and EMU is detailed in Box 2, and shows a relatively small effect on activity. The relatively muted effect on emerging economies, in spite of their relatively higher oil intensity of GDP, can be traced in part to a reduced pass-through of international to domestic oil prices. As chart 9 shows, in the previous cycle of increasing oil prices between 2003 and 2008, emerging economies only passed through about three quarters of the increase in international oil prices, compared to the full pass-through in advanced economies. This lower degree of pass-though in emerging economies has been repeated so far in the upward swing in prices since end-2008 and stems from an active use of subsidies to moderate swings in domestic prices. However, the implied fiscal costs of this policy will mean that only economies with ample fiscal space will be able to sustain them.

Accordingly, there are no substantial changes in our growth forecasts compared to the previous Global Economic Outlook in February, given that, in most cases, strong data in the first quarter is offsetting higher oil prices. The main exception is Mexico and South America, where some moderate upward revisions to growth forecasts are warranted given strong first quarter outturns and the windfall from higher commodity prices (Chart 10) lifting some of the bottlenecks in Argentina and Venezuela.

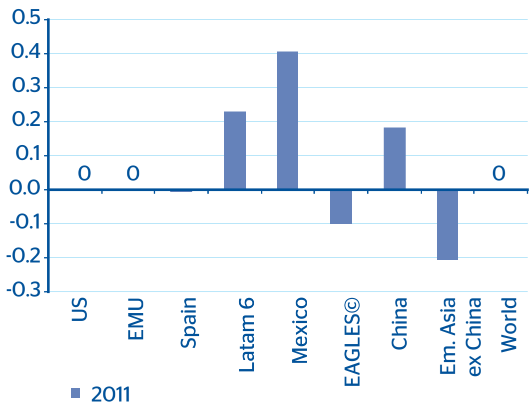
In general terms, Europe will continue its growth decoupling between core and periphery during 2011. In the US, risks to the projection are now tilted to the downside (they were biased to the upside three months ago) due to higher oil prices and the soft patch experienced in the first quarter, which we think will prove temporary.

Chart 9
Pass-through of international to domestic oil prices*




* Ratio of change in domestic price of hydrocarbons to the international spot price index, both measured in local currency
Source: BBVA Research and IMF

Chart 10
Changes in GDP growth forecasts for 2011, relative to February 2011 forecasts




Source: BBVA Research

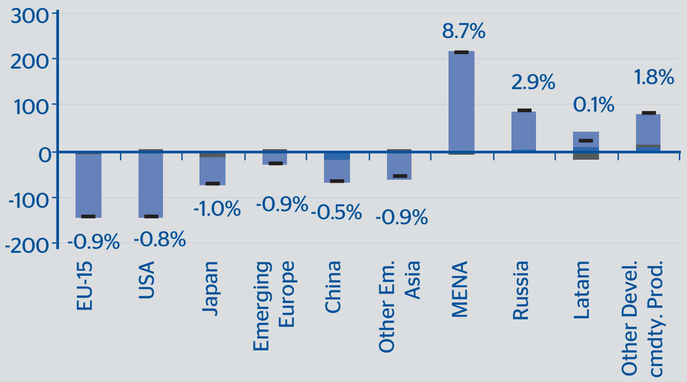
## Box 1. Winners and losers from high commodity prices

An increase in commodity prices represents a 'real' shock to the economy which leads to winners and losers among other things in terms of net income transfers from importing to exporting countries. During 2010 the overall income transfer associated to energy, metal and food imports reached 1.8 trillion US$, representing approximately 2.9% of global GDP. The biggest contributors to this sum were the G-3 countries, with more than 67% of worldwide transfers, followed by China (17%) and other Emerging Asia (11%). On the other side, the Middle East and North Africa (MENA) region got the biggest slice of the cake, with a 42% share, followed by Russia (19%) and Latin America (18%). More than 80% of the value regarding overall commodity flows was related to oil balances.

As described in the main text, the uncertainty surrounding how deep the ongoing civil unrest in the MENA region will be and how long it will last (and hence its implications in terms of oil supply), suggests that energy prices, particularly oil, could remain elevated in the near term. One direct effect of such scenario would imply a bolstering of the income transfers associated to commodities.

Based on the baseline scenario characterized by a moderated upward shock over all commodity prices, and relying on the last available trade data provided by the World Bank, we have computed the country-specific net income transfers as a share of the own country's GDP. Bear in mind, however, several caveats of the exercise: first, it assumes no effect of high prices on either demand or supply so this is just a pure terms-of-trade effect. Secondly, corresponding GDP figures for exporters or importers do not vary, when computing ratios of GDP. But all in all, this is a fair approximation to the first impact of the commodity shock on different regions of the world.

Chart 11
**Change in net transfers from 2010 to 2011 due to higher commodity prices (USD bn and % of own GDP)**




(*) Other Developed producers include Canada, Australia, Norway and Denmark. Emerging Europe includes Turkey. China includes Hong Kong
Source: BBVA Research based on World Bank, IMF and Haver Analytics

As a result, our 2011 baseline scenario implies an additional worldwide income transfer associated to energy, metal and food imports of around 500 billon dollars, representing approximately 1% of GDP being transferred from developed countries (G3) and East Asia to commodity exporters (see Chart 11). On the other hand, MENA countries and Russia become the main beneficiaries of net transfers (additional net receipts of 8.7% and 2.9% of their GDP, respectively). Latin America displays great heterogeneity across countries, as some will benefit from high oil prices (Mexico, Colombia and Venezuela) and elevated metal prices (Chile and Peru) but high food prices would compensate in part this positive effect, and provide a positive boost in Brazil and Argentina. On average, the effect on the region would be positive, although not too big.

## Box 2. Assessing the impact of high oil prices on the US and Europe

Crude oil accounts for around 33% of energy demand, according to the International Energy Agency. Adding natural gas and coal, the share of fossil fuels reaches almost 80%. Given the role of oil as a basic raw material in world production, changes in oil prices are bound to have significant effects on both world output growth and inflation.

Sharp rises of oil price tend to have a stagflationary effect on the economy. The magnitude of the impact of such a shock depends on several factors: its size and persistence, their dependence on oil as energy source and the policy response. Historically, oil shocks have contributed to each one of the global recessions of the last thirty years. For instance, the 1974-1975, 1980-1981, 1990-1991 recessions, as well as the current one, were partly triggered by spikes in oil prices.

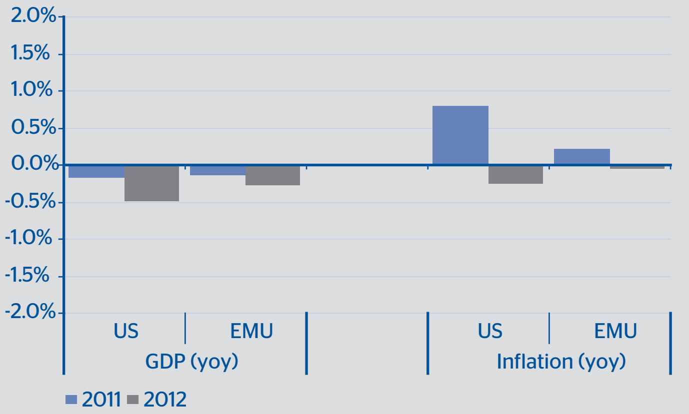
In this Box we present the estimated impact of an oil price shock on several key macro aggregates. The shock we attempt to model is intended to reflect current conditions in the oil market. The recent hike in oil prices may be thought of as a precautionary demand shock and not just a supply-side shock. We are observing a sharp increase in crude oil prices (arguably triggered by precautionary demand in the face of increased geopolitical risk) not accompanied by a fall in supplied quantities, since most lost production in Libya has been covered by other OPEC producers. In contrast, a supply shock is usually characterized by a reduction of quantities which leads to oil price rises and a slowdown in global economic activity.

In particular, our study assesses the responses to this shock on output growth, inflation and interest rates in two areas: the US and the EMU. Beyond the weight of these regions in global economic activity, they exhibit a marked dependence on oil in their energy mix, which largely comes from imports. In fact, crude oil supplies around 40% of total energy demands in the US and Europe, although the dependence ratio is far higher in the latter. Nevertheless, this feature must be counterbalanced with the fact that US production is more oil intensive than in Europe.

We estimate a SVAR (structural vector autoregressive) model that includes nine variables: Brent crude oil price and total oil production, GDP, CPI and official interest rates both for the US and EMU, as well as a proxy variable for global economic activity[1]. The sample used contains quarterly data from 1985 to the forth quarter of 2010.

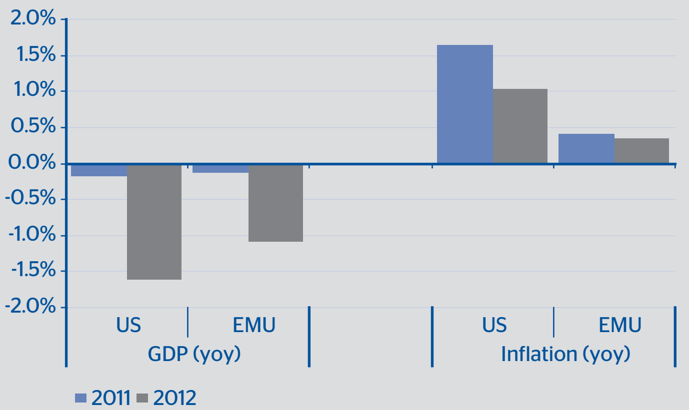
Following Uhlig (2005)[2], the shock in the oil market can be identified by imposing restrictions on the signs of the responses of the original VAR. In particular, taking into account the works of Peersman and Robays (2009)[3], the precautionary demand shock we attempt to analyze is characterized by requiring the impulse response functions to satisfy, in the face of a shock, that: (i) oil prices rise; (ii) oil quantities rise; and (iii) global activity decline[4]. Note that this is different from the standard oil supply shock of the 70s where we would observe declining oil production, instead of continued increases, and approximates the fact that increased geopolitical risk makes stocks more valuable and increases its demand.

Chart 12
**Effects of a temporary 25% increase in oil prices during one year**




Source: BBVA Research

Chart 13
**Effects of a permanent 50% rise in oil prices**




Source: BBVA Research and IMF

1: Composite Leading Indicator for industrial production index for 35 countries from the OECD.
2: Uhlig, Harald, 2005. "What are the effects of monetary policy on output? Results from an agnostic identification procedure", Journal of Monetary Economics, Elsevier, vol. 52(2), pages 381-419.
3: Peersman,Pert and Robays, Ine Van, 2009. "Cross-Country Differences in the Effects of Oil Shocks"
4: In fact, these conditions are met weakly.

Once the shock is identified, we are able to simulate different scenarios for the oil market. In particular, we are interested in analyzing the responses to: (i) a transitory shock in which oil price remains elevated around 120 dollars per barrel in 2011 and returns to 90-100 in 2012; (ii) a permanent shock in which the oil price rises to around 140 dollars per barrel and stays there persistently.

As expected, the model predicts that a shock of this kind leads to a reduction of output growth and an increase in inflation, regardless of the persistence of the shock. Also, a transitory shock (Chart 12) causes weaker effects than a permanent shock, which would be quite damaging to growth, bringing up a near recession in both areas (Chart 13). Note that inflation responds more intensively in 2011 (with a reduction in inflation in the second year after the temporary shock is over), but the greater effects on GDP are recorded later in 2012 due to the typical inertia of real variables.

Moreover, the effects in US growth are somewhat larger than in Europe, which might reflect (i) a greater oil intensity of US production; (ii) higher trade integration of Europe with oil exporters, thus benefiting from oil revenue recycling, (iii) a greater tax burden (lump-sum) on oil products in Europe, thus dampening the pass-through to domestic prices. This greater effect on output in the US is partly compensated by a smaller negative terms-of-trade effect the US, given its sizable domestic oil production.

# 3. Heterogeneous response from monetary policy

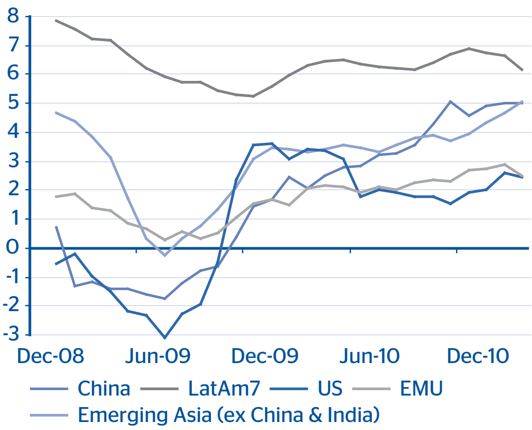
## The main effect of higher oil prices will be higher headline inflation in most economies in 2011

As described in the previous section, the effect of higher oil prices, sustained at around 120 dollars per barrel in 2011, would be relatively muted on economic activity. However, global headline inflation will of course suffer the direct impact from higher commodity prices.

Global inflation is currently running at around 4%, but with wide differences between advanced economies (slightly more than 2%) and emerging economies (more than 6%), as shown in Chart 14. Core inflation is still running well below headline inflation, although it has been rising strongly in emerging economies from slightly above 2% to close to 4% in the year to March 2011, reflecting smaller excess capacity and signs of overheating in some countries (see section 5).

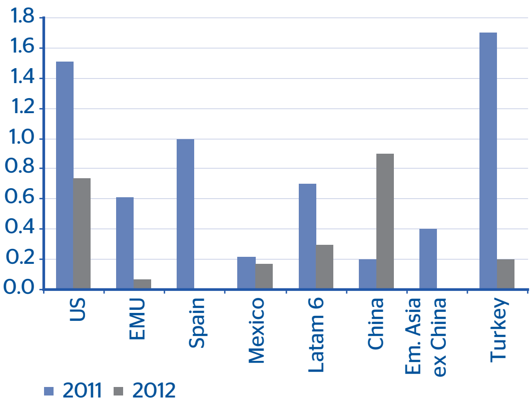
Going forward, higher-than-expected commodity prices will push inflation higher than anticipated 3 months ago (Chart 15), although the effect will be temporary if –as expected– oil prices stabilize at 120 dollars per barrel in 2011 and ease in 2012. It is important to note that, even though oil and food have a higher weight on CPI baskets in emerging economies, the upward revision in inflation forecasts is more pronounced in developed economies. This reflects the fact that most emerging economies with fiscal space are expected to resort to increased subsidies to soften the hike in domestic product prices, as also done in the past (Chart 9). However, in advanced economies the increase in headline inflation has not translated so far to core inflation, and there should be ample slack to contain those spillovers in the near future. Nevertheless, risks to the inflation outlook are tilted to the upside in all regions: in emerging economies those risks stem from possible stronger pass-through of oil prices and central bank credibility still being built, whereas in advanced economies, the moderating effect from economic slack could be smaller than anticipated.

Chart 14
Inflation (% yoy)




Source: BBVA Research and Haver Analytics

Chart 15
Changes in inflation forecasts for 2011 and 2012 with respect to February 2011




Source: BBVA Research

## The rise in headline inflation and the risks of second-round effects will prompt central banks to bring forward in time their expected interest rate hikes, but with wide heterogeneity across countries

As highlighted above, higher commodity prices will push up inflation somewhat differently across different economic areas. Yet, it is important to highlight that in our view, second-round effects via higher wages in advanced economies will not materialise and inflation expectations will remain anchored, helped by still ample productive slack and still weak labour markets.

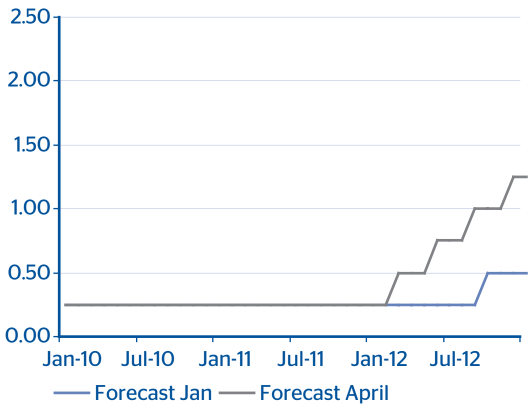
Monetary policy makers in the US and Europe are shifting –with different intensity– their focus from preventing a relapse into recession to maintaining inflation expectations anchored, particularly considering that their monetary policy stance is very accommodative. As a consequence, the balance of risks has tilted towards a higher probability of earlier hikes. The ECB hawkish approach is to avoid any risk of second-round effects on inflation by being pre-emptive, and does not seem willing to consider this oil price shock as temporary. Contrary to this, the Fed seems to focus more on the still weak recovery and has a vision of this commodity price shock as more temporary in nature.

In this context, we anticipate that the Fed would start increasing its Fed Funds target rate sooner than expected in our previous Global Economic Outlook in February. But still we think the Fed is in no hurry to hike rates in 2011 and its exit strategy will be very gradual. Our new baseline scenario assumes that the Fed will keep fed funds rate unchanged until March 2012 and implement its exit strategy gradually thereafter (Chart 16). At the same time, we also expect the Fed to end its latest unconventional monetary stimulus (QE2) in June this year and not extending it further, as envisioned when the programme was implemented in mid 2010.

The ECB's hawkish shift since March and its first rate rise in April makes it clear that it will be the beginning of a slow process of rate hikes, to allow a departure from the "very accommodative" stance which will take official rates to more reasonable levels, between 1.50% and 1.75% at the end of 2011 and –following a wait-and-see strategy– around 2% at the end of 2012 (Chart 17). This slow pace reflects the high uncertainty regarding the strength of the recovery and the evolution of inflation and their concern about the difficult situation of some euro area banking sectors –which also justifies its prolonged unconventional support to the financial sector–. In any case, we think these increases should be enough to stave off second-round effects from high oil prices and keep inflation expectations anchored.

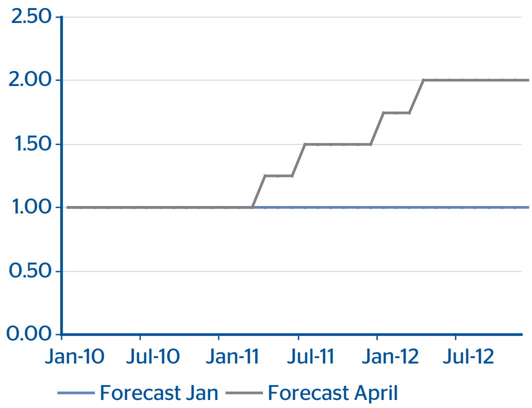
Interestingly, this will mean that this is one of the few instances where the ECB (or, previously the BundesBank) will undergo a tightening cycle ahead of the Fed. This has had already an effect on the appreciation of the euro, outweighing the effect of still high financial tensions in peripheral Europe and productivity growth differentials between the US and Europe. Higher interest rates and a stronger euro are contributing thus to tighter financial conditions in the EMU, not quite helping with the cyclical recovery in Europe.

Chart 16
**US: official interest rate forecast (%)**




Source: BBVA Research

Chart 17
**EMU: official interest rate forecast (%)**




Source: BBVA Research

## In emerging economies, higher commodity prices will add to the policy dilemmas generated by strong capital inflows and appreciating pressures

The increase in commodity prices also presents challenges for monetary policy in emerging economies. As mentioned above, rising oil and food prices and diminishing slack are pushing up inflation (core and headline) in emerging countries. In addition, most emerging economies are experiencing high rates of credit growth. However, the resulting tightening in monetary policy could lead to an overshooting of the exchange rate and strong capital inflows that could revert abruptly, especially once US monetary policy begins to tighten. Thus, many emerging economies have adopted macroprudential measures to tighten policy, and capital controls to soften concerns from capital inflows. However, the risk is that insufficient policy tightening might lead to a hard landing later. This is especially relevant as policy interest rates appear too low, given very accommodative monetary conditions at present.

# 4. Fiscal and financial risks in developed economies

## In Europe, the March summits have achieved progress in pushing reform and helping prevent future crisis, but solvency concerns have not been addressed properly, and will thus continue pressing peripheral countries

During the first quarter of 2011, financial market tensions in peripheral countries remained elevated (Chart 18), and efforts by the European authorities are proving fruitless, with no clear resolution in sight. Piecemeal approaches to the problem seem to have each time smaller positive effect on markets, which are waiting for a more comprehensive solution to the debt crisis to regain confidence.

European Council meetings held in March provided a good outline of future European governance on issues of economic coordination and crisis prevention. On the one hand, the Euro Plus pact proposed by Germany forces countries to submit each year reform programs in areas such as pensions, wage bargaining and fiscal rules. They are useful reforms for growth and fiscal sustainability in the medium and long term, but they do not address more immediate problems such as sovereign liquidity and solvency. The Euro Plus pact is far from optimal, especially given the lack of enforceability and the voluntary implementation of some of the agreements (peer pressure might not be sufficient to bring about the necessary reforms), but at least served to have Germany agree to other decisions dealing with sovereign concerns.

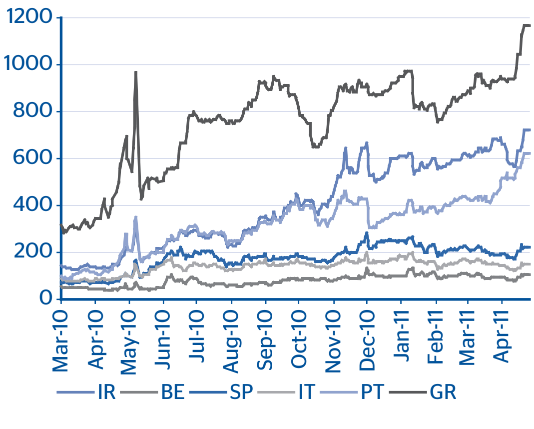
A second element is the reform of the Stability and Growth Pact (SGP), which will bring forward the review of national fiscal policies, including the control of private sector imbalances (which, except in the Greek case, have been the underlying cause of this crisis) and strengthen penalties for defaulting countries. Certainly this is a positive reform to prevent similar crises in the future, although leaving out political discretion in the application of sanctions and making them fully automatic would have been a much better outcome.

The third piece is the reform of the European Financial Stability Facility (EFSF) and the European Stabilization Mechanism (ESM) one of the most important tools to ease current tensions. EU countries committed themselves to increasing the effective lending capacity of the EFSF and making the ESM permanent in June 2013. The latter also increased its effective capacity to 500 billion euros, which can be used exceptionally to buy bonds in primary markets. This is certainly an improvement over the current framework and can help address sovereign liquidity problems. However, it fell short of expectations given the impossibility to purchase bonds in secondary markets, which would have made facilitated voluntary debt restructurings similar to Brady bonds in the 90s and relieved the ECB from its current burden of supporting sovereign bond prices in times of high distress.

The main problem with the agreements is that they have not addressed solvency concerns in peripheral countries. The uncertainty about the sustainability of sovereign debt in some countries (most notably Greece) increases the probability that private investors will have to face losses on their bond holdings, even before the bail-in system is in place in 2013. In the communiqués after the summits, it is not at all clear that existing bonds cannot be subject to restructuring. Furthermore, from the beginning, EU and IMF funds have seniority over private debt. While these debt restructuring concerns continue, debt spreads will remain high in Greece, Portugal and Ireland, with a dispersion in interest rates unseen since the creation of the monetary union (Chart 19). This will imply the need for further action down the road by European authorities, which have just bought time (once again) with the decisions adopted in March.

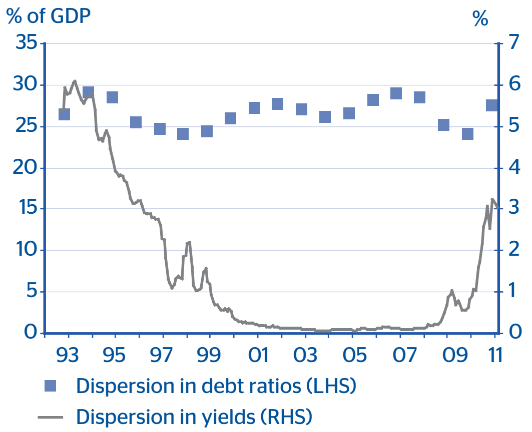
Adding to this, declarations in favour of debt restructuring by European officials (most notably the German Minister of Finance) and rumours that the IMF would also support this measure, have spooked markets in late April. In this context, markets increasingly view as insufficient a mere extension of deadlines for official debt. Given very high Greek banks' exposure to its own sovereign debt and also cross border exposures by European banks to Greek sovereign bonds and Greek banks (Charts 20 and 21), a strong restructuring, with haircuts for private investors, would have very harmful effects on the institutions concerned and, if not designed properly – either involving just public funds or a sharing arrangement between private and public creditors – would have a high potential for contagion to the rest of the European financial system and precipitating even worse financial market tensions than those experienced in the spring of 2010. The problem would be much more serious if the restructuring is done in a disorderly manner, reflecting reform fatigue in Greece. This highlights the urgent need for a comprehensive and ambitious plan for Greece, that needs to overcome the apparent political weakness by European authorities vis-à-vis their electorates.

Chart 18
10yr sovereign bond spreads to Germany (bps)



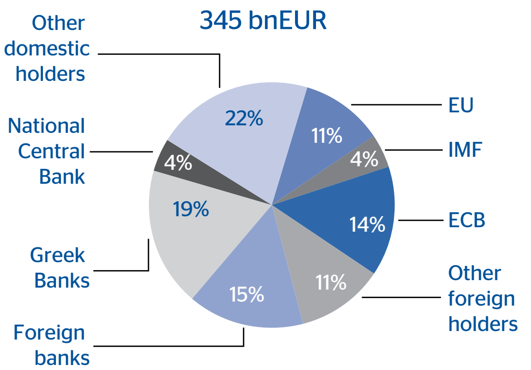

Source: BBVA Research and Bloomberg

Chart 19
Dispersion of debt levels and bond yields in the eurozone



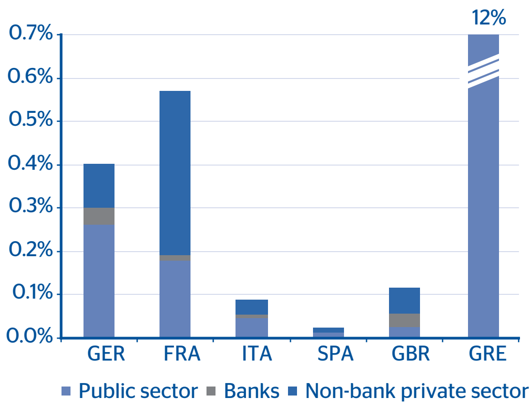

Source: BBVA Research and Haver Analytics

Chart 20
Holders of Greek sovereign debt (EUR bn)




Source: BBVA Research based on IMF, BIS and national authorities

Chart 21
Exposure to Greek assets by banks (% of own assets)




Source: BBVA Research and BIS

## In the US, negotiations for a fiscal deficit reduction will likely end in a true fiscal consolidation plan, but the political noise around the debate will likely add to uncertainty in the markets

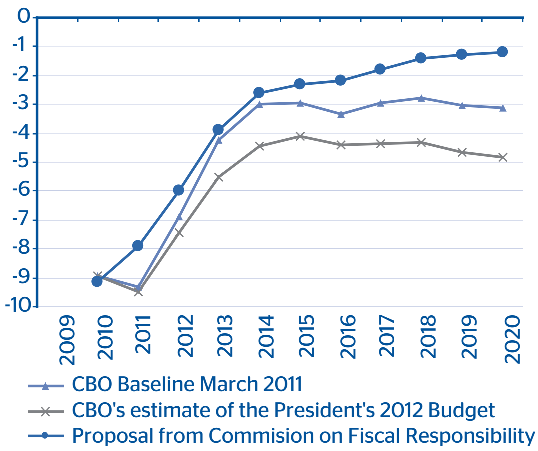
The inception of a fiscal consolidation process had been expected in the US for long. As a result of countercyclical fiscal policies over the last few years, the fiscal situation in the US had turned out fragile. However, at the end of 2010, when markets were expecting some measures to tackle the deficit, President Obama surprised with new expansionary measures. The deficit in 2011 is likely to remain at around a similar level than that of 2010 (slightly above 9% of GDP) with the debt ratio over GDP standing at nearly 70% (see Charts 22 and 23). In the baseline scenario, the US deficit is expected to level off at around 4% by 2015, which means that public debt would reach 75% of GDP. Given this outlook, the urgency for consolidation has become clear in the last few months. Rating agencies have pointed out that the US AAA rating was not warranted unless further measures were taken.

As a result of these prospects, woes have risen since the lack of fiscal consolidation efforts would increase the risk of an increase in long-term rates in the long-run. Over the last few months there has been a heated political debate around debt and deficits. In general, we expect a lengthy tug of war between entitlement cuts and increased taxes. This makes for a volatile political environment, but one gravitating towards deficit cuts probably in line with the proposal by the National Commission on Fiscal Responsibility and Reform. In this regard, it seems that there will be two upcoming fiscal battles. On the one hand, the debt ceiling, which Treasury expects to hit limit on May 16. However, politicians are likely to raise the debt ceiling to avoid turmoil in the markets. On the other hand, the initial presidential proposal for the 2012 budget includes some entitlement reform and a set a target of 4 trillion dollars in cuts over 12 years, shifting the burden to wealthy individuals.

However, the recommendations by the National Commission on Fiscal Responsibility and Reform go further. The Fiscal Commission Plan has 6 major components, including (i) discretionary spending cuts; (ii) a comprehensive tax reform with a sharp decrease in rates, a broadening of the tax base, simplifying the tax code, and reducing many “tax expenditures”; (iii) containment of health care costs; (iv) mandatory savings in agriculture subsidies and military and civil service retirement systems; (v) social Security reforms to ensure solvency, and (vi) reform the budget process. These reforms would imply a 4 trillion dollar cut over the next 10 years, so that the deficit would reach 2.3% of GDP by 2015 and debt would level off by 2014 (see Charts 22 and 23) and would reach 40% of GDP by 2035.

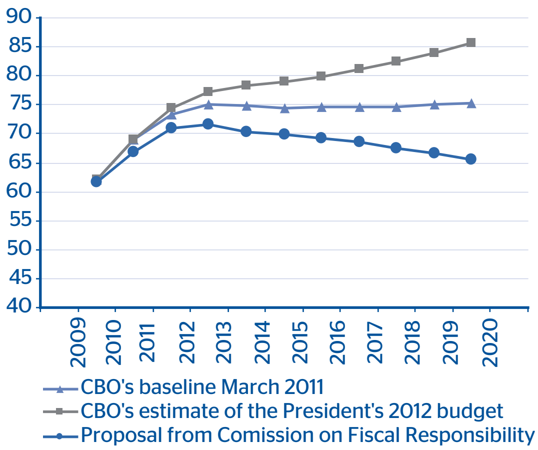
In any case, all this makes for a volatile political environment and intense debate that will be surrounded by a lot of political noise, which will add uncertainty surrounding the outcome. We expect the debate will gravitate towards cuts probably in line with the proposal by the National Commission on Fiscal Responsibility and Reform and that the final outcome will be a reduction in deficits and a more sustainable debt path.

Chart 22
**US: fiscal deficit (% of GDP)**




Source: BBVA Research

Chart 23
**US: public debt held by the public (% of GDP)**




Source: BBVA Research

## Box 3. Japan earthquake: deep short-term impact; lots of doubts ahead

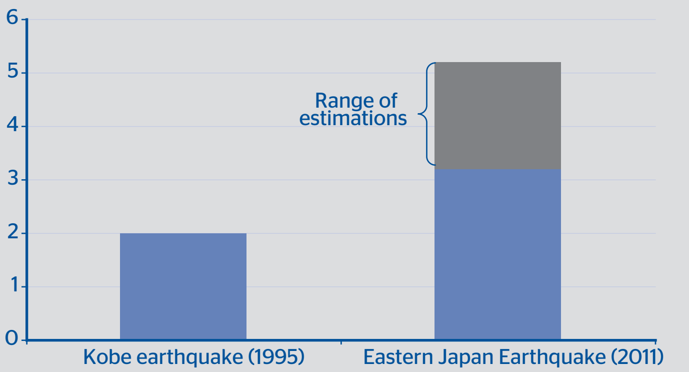
On 11 March 2011 a magnitude 9 earthquake struck Japan. The subsequent tsunami and nuclear crisis devastated the Tohoku region of the Northeast. These events turned out to be the worst natural disaster in Japan since at least the 1995 Kobe earthquake. Although figures are still provisional, the Japanese government estimates the human toll (including dead and missing) to be above 25,000. At the time of this writing, the Japanese authorities were still struggling to bring the situation at the Fukushima nuclear plant under control, and the consequences of further nuclear fallout were far from being known.

It is possible to analyze the economic consequences of this catastrophe from several perspectives. The most straightforward is to calculate the direct economic impact (property damage) of the earthquake. Even though there still is a great deal of uncertainty, there are some calculations of the direct impact of the earthquake. The affected region accounts for a relatively small share of national production – around 7% of Japan's GDP. The area most severely impacted by the earthquake and tsunami is a key agricultural region. It is also an important auto production center with significant raw material industries such as oil, steel, and pulp, as well as home to a number of nuclear power plants. The earthquake has damaged local infrastructure and caused many knock-on effects on the rest of the country. In addition to local infrastructure such as port, airports, and roads, the earthquake has damaged home, factories, and equipment. The Japanese government estimates this direct impact to be between ¥16-25 trillion, or between 3.3% and 5.2% of GDP, well above the damage caused by the Kobe earthquake of about 2% of GDP (See Chart 24).

In addition to the direct economic impact, it is important to calculate the indirect effect which relates to production and growth. Industrial production has fallen sharply since the earthquake as a result of the closure of businesses and shops, disruptions to transportation and supply networks, and key services like power and communications. Over the last few weeks, there have been factory shutdowns in key industries, particularly in automobile and electronics which accounts for a big stake in Japanese manufacturing. At the same time, power blackouts are expected to have significant impact on a wider range of industries. Furthermore, nuclear fears have undermined exports and tourism, and business sentiment as well. Indeed, as events have unfolded in recent weeks, estimates of the impact on supply chains and economic growth have increased (Chart 25).

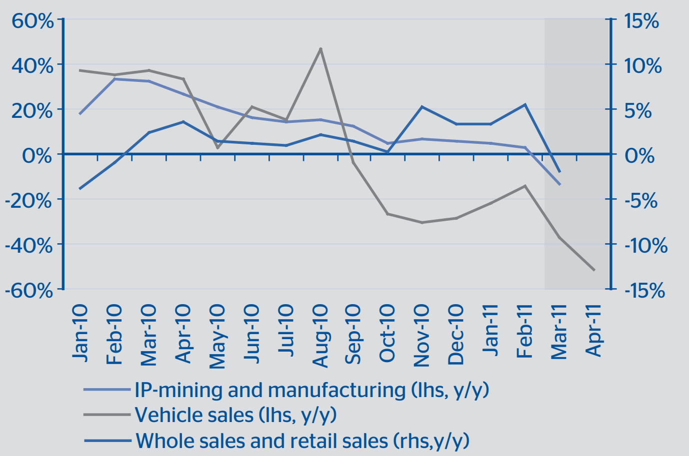
Obviously, the situation described above is likely to have huge adverse impact on the growth of Japan in the near term. At the time of the earthquake Japan's economic recovery was on track, although it remained fragile. In 2010, GDP growth bounced back to 3.9% from a -6.3% decline in 2009. Indicators before the earthquake pointed to a return of growth to its potential at around 1.5%, which was not all that high due to weak domestic demand, and aging population, and other structural factors. The recovery was unfortunately disrupted by the quake. Estimates of the economic impact of natural disasters on economic growth are always imprecise. That said, growth in 2011 could be expected to be dragged down significantly. On the other hand, slowdowns in the aftermath of these kinds of events are usually followed by strong rebounds as consumers resume spending (especially replacing damaged durable goods) and as public reconstruction spending boosts activity. In the case of 2011 earthquake, the negative impacts on growth are likely to be concentrated in Q1 and Q2, followed by a sharp rebound in the following quarters. In sum, in the near term we forecast Japan's real GDP growth to be 1 pp lower as a result of these effects, but for 2012 growth is likely to be higher than our previous estimate (see Chart 26)[5].

Chart 24
**Estimate of the direct impact of earthquakes in Japan**




Source: BBVA Research based on Japanese government data

Chart 25
**Post-quake activity indicators**




Source: BBVA Research and Haver Analytics

5: For a more detailed explanation of the market reaction and details about the activity indicators released in the first days after the earthquake along with more details about the revised estimates of GDP see Global Economic Watch: Economic Impact of Japan Quake of 16 March 2011.

The quake is estimated to be the most costly natural disaster in Japan's history, in part due to the potential lasting effects of radiation from the Fukushima nuclear plant. In fact, there are a lot of uncertainties surrounding these figures and the risk is clearly tilted to a worsening of the situation. Meanwhile, power blackouts also add to uncertainty about the effects on economic activity. Therefore, the final impact of the quake could be higher than current estimates. Nonetheless, the impact should still be only limited to the near-term growth outlook.

Will the disaster lead to an early end to deflation? Before the earthquake, deflation was expected to last until mid-2012. Japanese deflation is a result of weak domestic demand on one hand and abundant production capacity on the other hand. The ensuing reduction in supply after the quake is pushing inflation, even more so given that the affected area is an important food producer. Increased spending on reconstruction could also have an inflationary effect. However, the impact on inflation should be only limited, offset by the downward pressure on prices from decreasing demand affected by weakened confidence. Therefore, we expect deflation to end toward the end of 2011, earlier than pre-quake forecast of mid-2012.

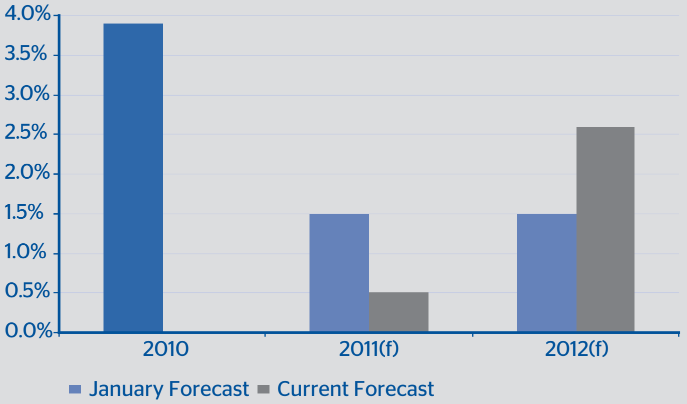
Will global economic growth be affected? Japan is the third largest economy in the world. However, it is unlikely that any Japanese demand slump would seriously affect the pace of the global recovery. In fact, some countries may see an increase in exports to Japan as the reconstruction takes place. However, more concerns emerge from the disruption of supply chain Some disruptions in global supply chains from Japan, especially auto parts, have already affected regional economies in Asia and Europe. As can be seen on Chart 27, several Asian countries are highly exposed to trade with Japan, particularly Taiwan and Thailand. However, the supply chain disruption should be temporary as factories recover their production in a couple of months.

Is there enough fiscal room to support reconstruction? How will exchange and interest rates be affected?

Japan's weak fiscal position is clearly a downside risk to the conventional V-shaped recovery after a natural disaster. The reconstruction effort comes at a time when fiscal space is already constrained with public debt at around 200% of GDP, prompting recent downgrades of the sovereign credit outlook by rating agencies.

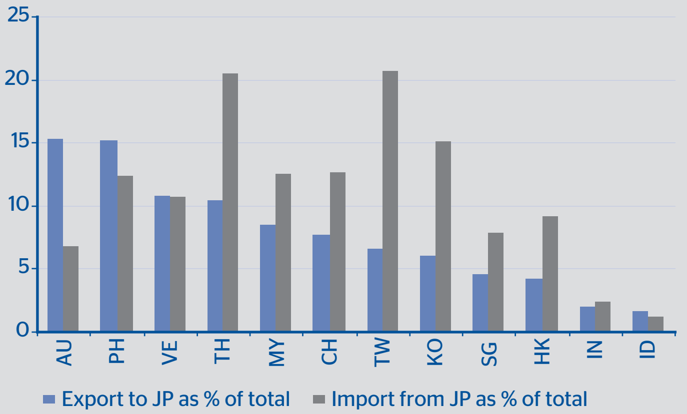
Clearly, extra budgetary spending for relief work and reconstruction after quake has undermined the government's efforts to tackle the deficit. Japan has passed the first supplementary budget of ¥ 4 trillion (0.5% of GDP). The extra budget is based on a reallocation of spending from other uses and should not increase either the deficit or the bond issuance. However, further extra budget spending will no doubt incur new debt issuance. It is possible that the reconstruction spending will be partially financed by increasing the sales tax rate, which is likely to undermine the strength of the recovery. At the time of this writing, no tax measures had been passed, although the government had already acknowledged, even before the earthquake, that a 3% increase in tax on consumption was under consideration. Regarding interest rates, the likely worsening in fiscal position should exert some upward pressure on long-term rates. However, since most of the public debt is held domestically, this effect should be small and manageable. In the short term, the Bank of Japan is expected to keep policy rates at the current level of 0-0.1%. On the exchange rate front, the Bank of Japan, together with the G7, intervened in the foreign exchange rate market at the outset of the crisis, resisting the appreciation pressure due to repatriation capital inflows after quake. The yen has not appreciated as severely as it did in the aftermath of Kobe's earthquake. Nevertheless, the yen remains under appreciation pressure.

Chart 26
**Japan's GDP growth forecast (%)**




Source: BBVA Research and IMF

Chart 27
**Asian countries' trade with Japan**



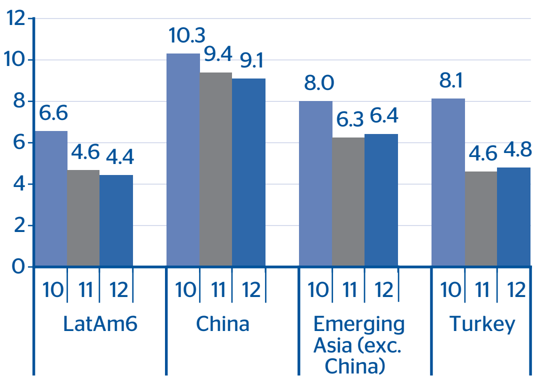

Source: BBVA Research and Bloomberg

# 5. Risks of overheating in emerging economies

## Emerging economies continue to show risks of overheating, given outturns from the first quarter of 2011, but with marked heterogeneity

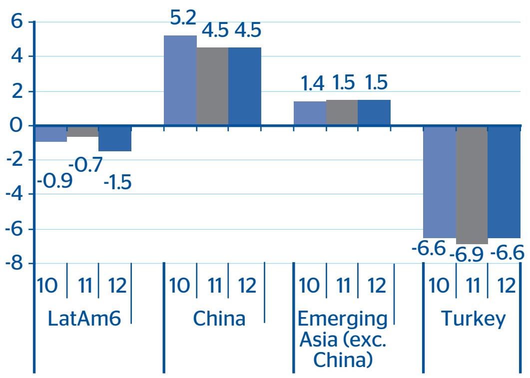
In most emerging economies in Asia and Latin America, economic growth is strong, and activity levels are above pre-crisis levels and trends –with the important exception of Mexico and Turkey–, implying that the recovery is more or less complete. As described before, one indicator that economic slack is greatly diminished is high inflation in many economies. Taken as a whole, inflation in emerging countries has been rising (Chart 14) and now stands above 6%, around a quarter of a percentage point more than at the beginning of the year. Core inflation has also been on the rise, suggesting that not all the effects are coming from higher commodity prices, but also domestic demand pressures stemming, in many cases, from highly lax economic policies. Moreover, in most countries under inflation-targetting regimes, headline inflation is already above target bands or in the upper half of it. In addition, some major emerging market economies are seeing annual rates of credit growth above 20% in real terms (Brazil, India, Hong Kong, Turkey) and fast-rising property prices, increasing concerns that a credit boom and a subsequent correction in property prices might be in the making. Economic activity in the first quarter of this year generally surprised to the upside, both in Asia and Latin America, postponing the expected slowdown in both areas, although we still project a deceleration in 2011 and 2012 (Chart 28).

Chart 28
**GDP growth in emerging economies (%)**




Source: BBVA Research

Chart 29
**Current account balances in emerging economies (% GDP)**




Source: BBVA Research

## Some countries are beginning to confront overheating risks with policy tightening measures, mostly monetary and macroprudential, but in some cases also fiscal

In this context, many emerging economies will need to continue tightening policies to reduce the risk of overheating and a subsequent hard landing. In most economies, monetary policies will need to continue tightening, especially since official interest rates in real terms still seem too low and monetary conditions remain highly accommodative. Indeed, higher commodity prices will push most central banks in both regions to bring forward their expected rate hikes as compared to expectations in our previous Global Economic Outlook 3 months ago (Chart 2). But these measures will need to be complemented also with macroprudential tools, to rein in credit and asset prices, especially real estate and with more decisive fiscal tightening, taking advantage of a favourable cyclical position to reinforce fiscal balances. Some countries, most notably China and Brazil have already started to confront overheating risks with policy measures on the monetary and fiscal front, although a more concerted effort is needed throughout Asia and Latin America.

As described above, one important trade-off for policymakers in both regions is the possibility of pulling large capital inflows as they tighten monetary policy. The risk here is that capital flows might turnaround quickly once US monetary policy tightening starts, which is why prudential measures and appropriate banking regulation and supervision is essential to limit the fallout from such a reversal.

### Going forward, high commodity prices will provide further tailwinds to South America, but headwinds for Asia, thus increasing overheating concerns in Latin America

Overheating pressures are more or less similar in Asia and Latin America at this point. However, going forward, there are three elements that might point to higher risks of overheating in Latin America. First, higher commodity prices represent further tailwinds for Latin America, as a commodity exporter region, while they are cooling headwinds for most economies in emerging Asia. Second, current account balances show comfortable surplus in most of Asia, but not so in Latin America (Chart 29), even with the positive shock to the terms of trade in the region, as imports have outpaced exports. This is not only a sign of domestic demand pressures, but also shows that the region has thinner buffers to avoid a hard landing in case of actual overheating. Finally, the effect of the earthquake in Japan might end up having a stronger-than-anticipated impact on regional supply chains, thus providing further headwinds to Asia. These risks point to the need of further policy tightening in both regions, but especially in Latin America, and also the need for fiscal policy to share some of the burden of tightening with monetary policy.

# 6. Tables

Table 1
Macroeconomic Forecasts: Gross Domestic Product

| (YoY growth rate) | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|
| United States | 0.4 | -2.6 | 2.9 | 3.0 | 2.7 |
| EMU | 0.3 | -4.1 | 1.7 | 1.7 | 1.5 |
| Germany | 0.7 | -4.7 | 3.5 | 2.7 | 2.0 |
| France | 0.1 | -2.5 | 1.5 | 1.7 | 1.6 |
| Italy | -1.3 | -5.1 | 1.1 | 1.0 | 1.0 |
| Spain | 0.9 | -3.7 | -0.1 | 0.9 | 1.6 |
| UK | -0.1 | -4.9 | 1.3 | 1.4 | 1.6 |
| Latin America * | 5.3 | -1.1 | 6.6 | 4.6 | 4.4 |
| Mexico | 1.5 | -6.1 | 5.5 | 4.7 | 3.8 |
| EAGLES ** | 6.6 | 3.5 | 8.3 | 6.9 | 6.9 |
| Turkey | 0.7 | -4.7 | 8.1 | 4.6 | 4.8 |
| Asia Pacific | 5.6 | 3.8 | 8.0 | 6.4 | 6.7 |
| China | 9.6 | 9.2 | 10.3 | 9.4 | 9.1 |
| Asia (exc. China) | 3.0 | 0.2 | 6.5 | 4.3 | 5.1 |
| World | 3.0 | -0.6 | 4.9 | 4.4 | 4.4 |

* Argentina, Brazil, Chile, Colombia, Peru, Venezuela
** Brazil, China, Egypt, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: April 30, 2011
Source: BBVA Research

Table 2
Macroeconomic Forecasts: Inflation (Avg.)

| (YoY growth rate) | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|
| United States | 3.8 | -0.3 | 1.6 | 2.8 | 2.2 |
| EMU | 3.3 | 0.3 | 1.6 | 2.4 | 1.6 |
| Germany | 2.8 | 0.2 | 1.2 | 2.3 | 1.5 |
| France | 3.2 | 0.1 | 1.7 | 2.1 | 1.6 |
| Italy | 3.5 | 0.8 | 1.6 | 2.3 | 1.8 |
| Spain | 4.1 | -0.3 | 1.8 | 2.9 | 1.2 |
| UK | 3.6 | 2.2 | 3.3 | 4.0 | 2.2 |
| Latin America * | 8.8 | 6.9 | 7.4 | 8.1 | 7.1 |
| Mexico | 5.1 | 5.3 | 4.2 | 3.9 | 3.9 |
| EAGLES ** | 7.4 | 2.8 | 5.2 | 5.2 | 4.7 |
| Turkey | 10.4 | 6.3 | 8.6 | 6.3 | 6.4 |
| Asia Pacific | 5.7 | 0.3 | 3.6 | 4.4 | 3.7 |
| China | 6.0 | -0.7 | 3.3 | 4.9 | 4.2 |
| Asia (exc. China) | 5.5 | 1.0 | 3.7 | 4.1 | 3.4 |
| World | 6.1 | 2.2 | 3.7 | 4.7 | 4.0 |

* Argentina, Brazil, Chile, Colombia, Peru, Venezuela
** Brazil, China, Egypt, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: April 30, 2011
Source: BBVA Research

Table 3

Macroeconomic Forecasts: Current Account (% GDP)

| | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|
| United States | -4.7 | -2.7 | -3.3 | -3.5 | -3.4 |
| EMU | -0.9 | -0.6 | -0.5 | 0.0 | 0.1 |
| Germany | 6.6 | 5.0 | 4.8 | 4.4 | 4.3 |
| France | -3.3 | -3.0 | -3.3 | -3.4 | -3.7 |
| Italy | -3.1 | -3.1 | -3.1 | -2.7 | -2.4 |
| Spain | -9.7 | -5.5 | -4.5 | -2.9 | -2.4 |
| UK | -1.6 | -1.3 | -2.2 | -1.5 | -0.2 |
| Latin America * | -0.7 | -2.5 | -0.9 | -0.7 | -1.5 |
| Mexico | -1.5 | -0.6 | -1.2 | -1.3 | -1.7 |
| EAGLES ** | 4.0 | 2.3 | 1.9 | 1.5 | 1.3 |
| Turkey | -5.6 | -2.2 | -6.6 | -6.9 | -6.6 |
| Asia Pacific | 4.8 | 3.8 | 3.2 | 2.9 | 2.9 |
| China | 9.9 | 6.1 | 5.2 | 4.5 | 4.5 |
| Asia (exc. China) | 1.4 | 2.3 | 1.8 | 1.8 | 1.8 |

* Argentina, Brazil, Chile, Colombia, Peru, Venezuela
** Brazil, China, Egypt, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: April 30, 2011
Source: BBVA Research

Table 4

Macroeconomic Forecasts: Government Deficit (% GDP)

| | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|
| United States | -3.2 | -10.0 | -8.9 | -9.7 | -7.6 |
| EMU | -2.0 | -6.3 | -6.0 | -4.5 | -3.5 |
| Germany | 0.1 | -3.0 | -3.3 | -2.7 | -1.5 |
| France | -3.3 | -7.5 | -7.0 | -5.6 | -4.5 |
| Italy | -2.7 | -5.4 | -4.6 | -4.1 | -3.1 |
| Spain | -4.2 | -11.1 | -9.2 | -6.0 | -4.4 |
| UK | -5.0 | -11.4 | -10.4 | -9.5 | -7.1 |
| Latin America * | -1.1 | -8.3 | -2.1 | -2.2 | -2.3 |
| Mexico | -0.4 | -0.7 | -0.8 | -0.7 | -0.6 |
| EAGLES ** | -1.8 | -5.3 | -3.6 | -2.8 | -2.4 |
| Turkey | -1.8 | -5.5 | -3.6 | -3.0 | -2.8 |
| Asia Pacific | -2.8 | -5.1 | -4.7 | -4.2 | -3.7 |
| China | -0.4 | -2.2 | -2.5 | -2.0 | -1.8 |
| Asia (exc. China) | -4.4 | -6.5 | -6.1 | -5.6 | -4.9 |

* Argentina, Brazil, Chile, Colombia, Peru, Venezuela
** Brazil, China, Egypt, India, Indonesia, Korea, Mexico, Russia, Taiwan, Turkey
Forecast closing date: April 30, 2011
Source: BBVA Research

Table 5
Macroeconomic Forecasts: 10-year Interest Rates (Avg.)

| | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|
| United States | 3.6 | 3.2 | 3.2 | 3.7 | 4.2 |
| EMU | 4.0 | 3.3 | 2.8 | 3.4 | 3.6 |

Forecast closing date: April 30, 2011
Source: BBVA Research

Table 6
Macroeconomic Forecasts: Exchange Rates (Avg.)

| US Dollar per national currency | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|
| United States (EUR per USD) | 0.68 | 0.72 | 0.76 | 0.73 | 0.75 |
| EMU | 1.47 | 1.39 | 1.33 | 1.37 | 1.33 |
| UK | 1.82 | 1.56 | 1.55 | 1.64 | 1.66 |
| China | 6.95 | 6.83 | 6.77 | 6.46 | 6.14 |

Forecast closing date: April 30, 2011
Source: BBVA Research

Table 7
Macroeconomic Forecasts: Official Interest Rates (End period)

| | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|
| United States | 0.61 | 0.25 | 0.25 | 0.25 | 1.25 |
| EMU | 2.73 | 1.00 | 1.00 | 1.50 | 2.00 |
| China | 5.31 | 5.31 | 5.81 | 6.81 | 7.31 |

Forecast closing date: April 30, 2011
Source: BBVA Research

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## This report has been produced by the Economic Scenarios Unit:

*Chief Economist for Economic Scenarios*
**Juan Ruiz**
juan.ruiz@grupobbva.com

**Rodrigo Falbo**
rodrigo.falbo@grupobbva.com

**Alejandro Fernández Cerezo**
alejandro.fernandez.cerezo@grupobbva.com

**Jaime Martínez Martín**
j.martinez.martin@grupobbva.com

**jorge Rodríguez Vález**
jorge.rv@grupobbva.com

With the contribution of:

*Cross Country Emerging Market Analysis*
**José Ramón Perea**
jramon.perea@grupobbva.com

*Regulation and Public Policy*
**Tatiana Alonso**
tatian.alonso@grupobbva.com

## BBVA Research

*Group Chief Economist*
**Jorge Sicilia**

*Chief Economists & Chief Strategists:*

*Financial Siystems and Regulatory:*
**Santiago Fernández de Lis**
sfernandezdelis@grupobbva.com

Financial Systems
**Ana Rubio**
arubiog@grupobbva.com

Regulatory Affairs
**María Abascal**
maria.abascal@grupobbva.com

Pensions
**David Tuesta**
david.tuesta@grupobbva.com

*Financial and Economic Scenarios:*

Financial Scenarios
**Sonsoles Castillo**
s.castillo@grupobbva.com

Economic Scenarios
**Juan Ruiz**
juan.ruiz@grupobbva.com

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

Spain
**Miguel Cardoso**
miguel.cardoso@grupobbva.com

Europe
**Miguel Jiménez**
mjimenezg@grupobbva.com

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

Global Equity
**Ana Munera**
ana.munera@grupobbva.com

Global Credit
**Javier Serna**
javier.serna@grupobbva.com

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

*United States and Mexico:*

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

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

China
**Daxue Wang**
daxue.wang@bbva.com.hk

India
**Sumedh Deorukhkar**
deorukhkar@grupobbva.com

South America
**Joaquín Vial**
jvial@bbvaprovida.cl

Argentina
**Gloria Sorensen**
gsorensen@@bbvafrances.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. + 34 91 374 60 00 and + 34 91 537 70 00
Fax. +34 91 374 30 25
bbvaresearch@grupobbva.com
www.bbvaresearch.com
Legal Deposit : M-31256-2000